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DEPOSIT INSURANCE REFORM AND FINANCIAL MODERNIZATION

HEARINGS

BEFORE THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

ONE HUNDRED FIRST CONGRESS

SECOND SESSION

ON

REFORMING FEDERAL DEPOSIT INSURANCE, MODERNIZING THE REGULATION OF FINANCIAL SERVICES, AND MAINTAINING THE INTERNATIONAL COMPETITIVENESS OF U.S. FINANCIAL INSTITUTIONS

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APRIL 3, 18, 24, AND 26, 1990

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CONTENTS

VOLUME I OF III

TUESDAY, APRIL 3, 1990

Page

Opening statement of Chairman Riegle 1

Opening statement of:

  Senator Garn 2

  Senator Sanford 4

  Senator Shelby 5

  Senator Heinz 53

  Senator Graham 53

  Senator Sasser 87

  Senator Dixon 88

WITNESSES

Robert F. Downey, chairman, Securities Industries Association; partner, Goldman Sachs, New York, NY, accompanied by Edward I. O'Brien, president, Securities Industries Association; and Marc E. Lackritz, executive vice president, Securities Industries Association, Washington, DC 6

  Prepared statement 10

    Executive summary 11

    Introduction 14

    Federal deposit insurance reform 17

    Improving the regulatory structure 24

    Reconciling new bank powers with bank safety and soundness and fair competition 29

    Conclusion 38

  Supplement to prepared statement addressing questions at the hearing 40

    I. Regulatory supervision of financial services 41

    II. Response to analysis of the SIA proposal 47

  Response to written questions of Senator Heinz 519

Thomas G. Labrecque, president and chief executive officer, the Chase Manhattan Corp., New York, NY, on behalf of the American Bankers Association, the Association of Bank Holding Cos., the Association of Reserve City Bankers, the Bank Capital Markets Association, and the Consumer Bankers Association 54

  Prepared statement 58

    Summary 58

    Introduction 61

    The need for modernizing our financial structure 64

    Financial and regulatory structure 71

    Deposit insurance reform 73

    Other regulatory issues 76

    Conclusion 76

  Response to written questions of Senator Heinz 521

Panel discussion:

  Equal treatment here and abroad 89

  Reregulation? 92

  Too big to fail 95

  Deposit insurance 97

  Access to the discount window 100

Page

WEDNESDAY, APRIL 18, 1990

Opening statement of Chairman Riegle 105
Opening statements of:
  Senator Dixon 127
  Senator D'Amato 127

WITNESSES

Sherry Ettleson, staff attorney, Public Citizen, Washington, DC 106
  Prepared statement 110
    Effective, accountable regulation 112
    Ending the casino economy 117
    Restoring honest business practices 121
    Conclusion 124
Peggy Miller, legislative representative, Consumer Federation of America, Washington, DC 125
  Prepared statement 131
    Federal deposit insurance reform 134
    Understand the problem 136
    Provide a stable administrative environment with clear authority 136
    Strengthen regulatory policies 138
    Bank powers 140
Jane Uebelhoer, legislative director, ACORN [Association of Community Organizations for Reform Now], Washington, DC 142
  Prepared statement 145
    ACORN 146
    Broad principles for financial restructuring 147
    Deposit insurance: Proposal 1 148
    Deposit insurance: Proposal 2 148
    Regulatory reform 149
    Expanded powers 150
  Joint statement to Congress 151
  Open letter to Congress 155

TUESDAY, APRIL 24, 1990

Opening statement of Chairman Riegle 169
Opening statements of:
  Senator Garn 170
  Senator Dixon 413
  Senator Shelby 423

WITNESSES

Kenneth Whipple, president, Ford Financial Services Group; on behalf of the Financial Services Council 170
  Prepared statement 175
    Executive summary 176
    Appendix 1. Membership 193
    Appendix 2. Summary of S. 530 194
Philip Vallandingham, president, Independent Bankers Association of America; and president, the First State Bank of Barboursville, Barboursville, WV 203
  Prepared statement 206
    Summary 207
    Federal deposit insurance reform 210
    Should the current regulatory structure be improved? 224
    Deregulation 227
    IBAA's proposal for a "Consumer Financial Services Act" 243
    IBAA's response to the Bush administration's request for comments 248
  Response to written questions of Senator Kassebaum 613
David Silver, president, Investment Company Institute 390
  Prepared statement 394
    Summary 394
    Introduction 397
    The institute's reform program 398
    A proper approach to reform of the financial services industry 409

Page
David Silver, president, Investment Company Institute—Continued
    Prepared statement—Continued
        Conclusion 410

THURSDAY, APRIL 26, 1990

Opening statement of Chairman Riegle 435
Opening statements of:
    Senator Garn 436
    Senator Shelby 437
    Senator Dixon 438
    Senator Heinz 499

WITNESSES

Norman D. Flynn, president, National Association of Realtors 438
    Executive summary 442
    Prepared statement 444
        Introduction 444
        Overview 444
        Deposit insurance reform 445
        Current regulatory structure 446
        Bank performance in real estate lending undermines expanded powers proposals 448
        EC '92—Implications for U.S. financial institutions; inherent structural problems 449
        Conclusion 449
Stephen J. Friedman, executive vice president and general counsel, the Equitable Life Assurance Society of the United States, on behalf of the American Council of Life Insurance and other representatives of the insurance industry 450
    Prepared statement 453
        Expanding bank insurance powers 454
        Deposit insurance reform 463
        Conclusion 473
    Response to written questions of Senator Bryan 616
William V. Irons, president, Irons and Associates; Rhode Island State Senator; on behalf of the National Association of Life Underwriters 474
    Prepared statement 477
        Summary 478
        Federal deposit insurance is designed to help consumers 480
        The presence of Federal deposit insurance gives banks an unfair advantage when they enter nonbanking businesses—and threatens to harm consumers 481
        Conclusion 486

ADDITIONAL MATERIAL SUPPLIED FOR THE RECORD

Harvard University, Professor Benjamin M. Friedman, response to Senator Riegle's written questions pertaining to a hearing held by the Senate Banking Committee on November 14, 1989 with Professor Friedman testifying 508

DEPOSIT INSURANCE REFORM AND FINANCIAL MODERNIZATION

VOLUME I OF III

TUESDAY, APRIL 3, 1990

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The committee met, pursuant to notice, at 10:05 a.m., in room SD-538, Dirksen Senate Office Building, Senator Riegle (chairman of the committee) presiding.

Present: Senators Riegle, Dixon, Sasser, Sanford, Shelby, Garn, Heinz, and Bond.

OPENING STATEMENT OF CHAIRMAN RIEGLE

The CHAIRMAN. The committee will come to order.

Let me welcome all those in attendance this morning, and particularly our witnesses who I will introduce just a little bit later.

Today we begin a series of hearings on modernizing our financial system, reforming Federal deposit insurance, and maintaining the international competitiveness of American financial institutions. During the next few months, this committee will review these issues in depth so that we can be fully prepared to consider specific legislation as soon as the administration develops and sets forward its own thinking on the subject. That does not mean that we will not have our own view here on this committee, but we will certainly want to put our view beside that of any proposal that the administration puts forward.

Over the course of the remainder of this year we have scheduled now some 13 hearings to lay a full foundation, looking at this issue from a number of different points of view. In fact, we will not only be hearing from the broad range of expert witnesses that one might expect from within our own country, but we will be inviting some foreign international experts to testify. So we can begin to understand the realities in this international financial marketplace and hear reflections on some aspects of the competitive situation from those that are outside our country but very much deeply involved in this business sector.

Our hearing today is on financial modernization. We have asked the witnesses to deal with recent proposals and new developments in the area, and to focus upon three questions:

First, how do they think the current system of Federal deposit insurance might be reformed.

Second, what they think should be done to improve the current regulatory structure.

And third, should new powers—and if so, which powers—but should new powers be granted to banks or their affiliates? And if so, not only what those powers would be, but when they should take effect, and with what protections for the deposit insurance fund.

We all know that in recent years old barriers in the world of financial services have increasingly been eroded. In the 2 years since the Senate passed the Proxmire Financial Modernization Act, this trend has continued. One of the dynamics has been a process of deregulation by loophole in which regulators and the courts have broadened the securities and insurance powers of banks and affiliates in a manner that would not be in a sense done by direct written law.

I understand, and I think the members of this committee do, the pressures for change and believe there is much to be said for legislative action to modernize our financial system, and particularly so as we look at the way the world financial system continues to integrate itself and we see momentous events taking place—not just the collapse of communism and the opening up of the Berlin Wall and the movement of Eastern Europe in the direction of the free markets, but also of course what we see in Europe 1992 and other major developments that are taking place around the world.

But before we can move forward, we must be sure we have protected the deposit insurance fund and the taxpayer. We must also be sure we have in place a strong, streamlined regulatory apparatus and one that facilitates effective supervision. Congress needs to determine what financial structure will best promote an efficient and yet safe and sound financial system.

Our financial institutions must be competitive worldwide, but they must also operate safely so the taxpayers' funds are not at material risk.

Before we get to our witnesses, I want to call on Senator Garn, and then I will call on my other colleagues.

Senator Garn.

OPENING STATEMENT OF SENATOR GARN

Senator GARN. Thank you, Mr. Chairman.

I certainly commend you for holding these hearings on modernization of the financial services industry. As you very well know, having served together with me on this committee for a number of years, this is a subject that is rather near and dear to my heart. I have been on record countless times on the issue throughout my tenure on this committee.

The committee's hearings on this subject have now filled more than 20,000 pages over the period of time that I have been here. During this time, there have been sweeping changes in the capital markets, including the dramatic impact of the internationalization of the capital markets. Despite all of these changes in the marketplace, we continue to deal with the same basic laws when it comes to financial services' powers as we did in the 1930's.

In 1988 the Senate did take action by passing the Proxmire Financial Modernization Act by an overwhelming vote of 94 to 2. This is not unusual after the passage of Garn-St Germain in 1984. I think there was an 89 to 5 vote in the Senate. And ever since the early 1970's, the Senate has been passing bills, and the House has been turning them down with their heads stuck in the sand.

Because Congress failed to act, the courts, States and the agencies are taking it into their own hands. Change has been occurring in a crazy-quilt fashion, accompanied by needless costs and uncertainties without clear direction from Congress. Mr. Chairman, if the need for action was important throughout the 1980's, it seems to me that it is critical now if U.S. financial institutions are to remain competitive in the world economy.

The changes that will take place in Europe at the end of 1992, as well as the dramatic opportunities that have opened up in Eastern Europe, present new challenges to our financial institutions. Are U.S. financial institutions going to have a major role in these developments? Or will the Western European or Japanese institutions lead the way? Not one U.S. bank is among the world's ten largest banks. They are all Japanese.

I believe that many of my colleagues on this committee agree that the time to act, and to act decisively, is upon us. The chairman has scheduled a series of hearings on financial modernization for this year with a number of excellent expert witnesses who will no doubt bring important perspectives to the debate.

Moreover, the committee has before it a number of existing proposals and extensive testimony. As we address the issues over the next few months, I will be particularly interested in the following two principles:

One, eliminating artificial barriers to competition and permitting U.S. financial institutions to compete on a level playing field both at home and abroad;

Two, protecting the deposit insurance funds and the U.S. taxpayer from unwarranted risk, and providing effective regulatory oversight.

I think it is appropriate that we are starting this series of hearings with distinguished representatives of the banking and securities industries. As I have said in the past, banks and securities' firms are already in each others backyards and they have been for years. That is the reality of the marketplace.

I am pleased that the dialog has moved to recognize that fact. The debate is no longer if this should be the case, but how it should be accomplished safely and soundly.

Gentlemen, I appreciate you being here today and look forward to your testimony.

The CHAIRMAN. Senator Sanford.

Senator SANFORD. Mr. Chairman, I will not make much of a statement, but I would like to enter into the record my opening statement which commends you for calling this hearing, and commends these two distinguished witnesses for struggling to reach a consensus among their groups of such diverse opinions, and to certainly forward to our consideration of these substantial changes that will make our institutions stronger, more flexible, more competitive, and I trust safer as we look at structure and the insurance process and the powers and authority of institutions.

So I think this is going to be an extremely useful consideration, and I thank you for calling it and asking the questions, and these witnesses for assisting us by being here.

The CHAIRMAN. Thank you, Senator Sanford. We will make your statement a part of the record.

OPENING STATEMENT OF SENATOR SANFORD

Senator SANFORD. Thank you, Mr. Chairman, and I would like to thank our witnesses, Tom Labrecque and Bob Downey for being with us this morning. Today's hearing marks the beginning of a critical effort by this committee—to modernize our financial services system to permit all financial services players to compete here and in an increasingly global environment while protecting the taxpayers from excessive risks resulting from deposit insurance. I appreciate the thoughtful testimony presented to us and don't doubt the difficulty of both our witnesses in arriving at views that are agreed upon by the diversity of institutions that our two witnesses represent this morning.

Certainly the events of the last year and even the last few months have demonstrated the tremendous changes that confront our financial system—from the savings and loan crisis, to the fall of the once-mighty Drexel Burnham, to the slide in the Tokyo Stock Exchange, to the integration of the markets in Europe. We must ensure that our financial system is flexible enough, yet strong enough, to adapt to these changes and to remain the efficient, competitive industry that our economy and our country needs it to be.

In a hearing held in this committee less than a month ago, John Gutfreund from Salomon Bros. discussed a number of ideas for a broad restructuring of our financial system. He concluded by stating that we have much work to do and that its time for us to "get to it." I certainly agree. I believe that this committee must be willing to examine critically the myriad of proposals to reform our deposit insurance system to ensure that savers have a safe place to keep those savings yet restoring some market discipline to our banks and thrifts.

I commend you, Mr. Chairman, for your efforts in starting to get this process underway and look forward to ongoing debates on methods for reforming our deposit insurance system. I believe that deposit insurance reforms are the key to coming up with a modernized structure that can permit our institutions to compete more effectively without placing undue risks on the taxpayers.

This morning's hearing gives us the opportunity to focus on these and a variety of issues that are critical to the long-term health and stability of our financial system. Again, I thank our witnesses for their thoughtful testimony and look forward to discussing a number of these issues with them.

The CHAIRMAN. Senator Shelby.

Senator SHELBY. Thank you, Mr. Chairman.

Mr. Chairman, I ask unanimous consent that my statement be made a part of the record. I would just like to tell you that you start with courage when you start with the two representatives of the two trade associations that have traditionally been the biggest rivals here today, and I look forward to their testimony here.

The **Chairman**. Thank you, Senator Shelby.

We will make your statement a part of the record.

OPENING STATEMENT OF SENATOR SHELBY

Senator **Shelby**. Mr. Chairman, I commend you for scheduling this morning's hearing and for having the courage to start with representatives of the two trade associations that have traditionally been the biggest rivals.

Gentlemen, I have looked over your testimony. I am pleased to note that both of you acknowledge that financial modernization cannot come without a determination that risk to the deposit insurance system and subsequently to the taxpayer, has been satisfactorily minimized or eliminated. One of the biggest lessons of the savings and loan crisis is that the assumption of undue risk should not be supported with the Federal safety net.

I am in agreement with both of you that the financial system should be modernized. Our financial institutions find themselves at an increasing disadvantage to those of our foreign competitors. Though I have heard convincing logic to the contrary, it bothers me greatly, that we as the world's preeminent military and economic power, have only one bank, near the bottom of the list of the world's top thirty banks. Because the availability of credit and the services with which this credit is packaged are catalysts to other economic activity, it is essential for the competitiveness of this country that we have a financial system that can keep pace with the challenges from aboard.

The world and the needs of business have changed since this committee considered this issue a couple of years ago. The lessons of the savings and loan crisis, progress in Europe toward 1992, the prospect for changes in Japan, and expanded business opportunities all over the world dictate that we must evaluate the issue of financial modernization from a fresh perspective.

I am here today, ready to listen. I regret that I cannot stay for the entire hearing but I will see that I catch up on what I miss. Thank you, Mr. Chairman.

The **Chairman**. I noticed that they appeared to be cordial to one another at the table, they are actually seated rather close to one another, and they are both smiling, there seems to be some degree of warm feeling.

Senator **Shelby**. Mr. Chairman, it is early in the day, though. [Laughter.]

The **Chairman**. Let me also acknowledge as I look around the room, I see that a former House colleague, Lud Ashley, is present. We are delighted to have him here. I also notice that former staff director Ken McLean is here, and there may be others that are further back in the room I am not seeing with my fading eyesight, but we welcome you here today.

Let me now introduce our two witnesses. First will be Mr. Robert Downey who is chairman of the Securities Industries Association and a partner of Goldman Sachs, who will be followed by Thomas Labrecque who is the president and chief executive officer of the Chase Manhattan Corp. Mr. Labrecque will be representing five organizations—the American Bankers Association, the Association of Bank Holding Companies, the Association of Reserve City Bankers, the Bank Capital Markets Association, and the Consumer Bankers Association.

So, gentlemen, we have your statements and we would like to hear your summary comments at this time.

Mr. Downey.

STATEMENT OF ROBERT N. DOWNEY, CHAIRMAN, SECURITIES INDUSTRIES ASSOCIATION; PARTNER, GOLDMAN SACHS, NEW YORK, NY, ACCOMPANIED BY EDWARD I. O'BRIEN, PRESIDENT, SECURITIES INDUSTRIES ASSOCIATION; AND MARC E. LACKRITZ, EXECUTIVE VICE PRESIDENT, SECURITIES INDUSTRIES ASSOCIATION, WASHINGTON, DC

Mr. DOWNEY. Thank you, Mr. Chairman.

The Securities Industries Association is honored to be included in this most important series of hearings and is grateful on behalf of its members and the citizens of this country that the committee is undertaking this review.

I am Robert N. Downey, the 1990 chairman of SIA and a partner of Goldman Sachs and Co., an international investment banking firm. With me today are Edward I. O'Brien, the full-time president of SIA; and Marc E. Lackritz, the full-time executive vice president of SIA and head of the SIA's Washington office.

We are eager to provide our assistance and the resources of SIA to the committee in the consideration of these critically important matters.

SIA represents over 600 firms active in the securities business. SIA's members range from large firms engaged in a full spectrum of national and international securities and securities-related activities to small firms engaged exclusively in retail brokerage. Its members are located throughout the United States and Canada. SIA member firms account for more than 90 percent of securities activities in North America.

The focus of these hearings is on our commercial banking system. The members of SIA do not pretend to be banking experts, but we are clearly interested parties to the proper resolution of the questions raised in these hearings. I would go further and suggest that, in light of recent experience with federally insured institutions, every American taxpayer is an interested party to the resolution of such questions.

We have moved far beyond the point where Congress or the public can dismiss questions relating to the appropriate scope of banking organization activities as involving no more than turf battles among various financial services providers. The crises surrounding our federally insured thrifts will be with us for quite some time. We all, be we members of the securities, banking, or any other industry, have an interest in extricating this country from this mess, or at the very least in ensuring that it never happens again.

SIA applauded the decision of Congress in FIRREA to commission studies of the Federal Deposit Insurance System. At a time when Congress and American taxpayers are facing bills of upward of $200 billion because of deregulation backed by Federal deposit insurance, it would appear only prudent that any financial restructuring occur in the context of legislation that also deals with deposit insurance reform.

George Santayna is no longer around to remind our bank regulators that those who do not learn from history are condemned to repeat it. We continue to believe that these policy decisions involving federally insured deposits should be made by our elected Representatives in Congress, not by regulators. Just as taxpayer money cannot be appropriated without congressional authorization, regulators should not be permitted to increase taxpayer risk without such authorization. If Congress does not act affirmatively to insulate federally insured institutions from new and existing risks of nonbanking activities, there is a substantial danger that the commercial bank bailout of 1993 will dwarf the thrift bailout of 1989.

The thrift situation is a result of misjudgments about what federally insured institutions should be permitted to do, and an unwarranted optimism about the ability of regulators and regulations to control risks. The Nation cannot afford a repetition of such a disaster.

At the same time, concerns are being raised about the competitiveness of our financial institutions in foreign markets. Some of our Nation's banks feel a need to expand into nonbanking businesses. They point to the loss of some of their business to alternative financial industries such as the securities industry which have invented less costly financing techniques to replace more expensive bank lending.

Meaningful reform proposals must reconcile the public policy objectives of preserving confidence in our financial system, promoting U.S. international competitiveness, protecting the deposit insurance funds and American taxpayers, and preserving the integrity of our U.S. financial markets. There are many technical issues involved in sorting through this maze of issues, many of them involving more detailed knowledge of the workings of the banking industry than I have. I believe, however, that resolution of the technical issues must occur within certain general principles.

These principles are relatively simple: First, as banks seek to diversify into activities outside their traditional depository and lending functions, SIA believes the Government support they receive should be neutralized. Many bank activities can and should be privatized. There are many proposals that address the normal limits of deposit insurance coverage. It is a reflection on the odd turns our deposit insurance system has taken that some of the proposals would reform deposit insurance by legislating that uninsured deposits will be covered at only 95 cents on the dollar. But the fact is that none of the proposals that would tinker with coverage levels will by themselves deal with the taxpayer risk issues that are of concern to this committee. True deposit insurance reform must involve a new hard look at how federally insured institutions use federally insured funds.

In describing certain securities hedge operations engaged in by one of the thrift institutions, the Wall Street Journal yesterday observed: "Very neat, but what public purpose does it serve to warrant the potential taxpayer liability implicit in insurance?"—deposit insurance, of course. This is the fundamental question that must be asked not only as to any proposed new activities of banks, but as to their existing activities as well. If the Government is going to support these activities, if the taxpayer is going to foot the bill if things go wrong, are they activities that as a public policy matter deserve such support? Is it necessary to burden the Federal deposit insurance funds and risk taxpayer liability with those particular activities?

There are certain core banking activities that deserve such support. The small depositor should have a secure place for his or her savings. The Government support appropriately creates confidence for such depositors that they will get their money back at par when they need it. Similarly, the use by banks of federally insured and therefore federally subsidized deposits to make retail loans to consumers who might not otherwise have access to credit at favorable rates serves a worthy public purpose.

But what about underwriting and dealing in securities, speculative foreign exchange transactions, commodities trading?

These activities are being performed competently and efficiently in the private sector without Government support or taxpayer liability. If banking organizations are to engage in these activities at all, they should do so in separate affiliates that do not have access to or imperil federally insured funds of affiliated banks.

A second basic principle is that there must be self-executing statutory rules that describe what activities can be conducted in federally insured units of banking organizations, what activities can be conducted in other units of banking organizations, and how these activities will be kept separate. It is both unfair and unrealistic to expect regulators, however well-meaning and competent, to keep track of our thousands of federally insured institutions and millions of increasingly complex and fast-moving transactions. Regulators can help implement a detailed structure for financial services designed for bank diversification consistent with safety and soundness, but should not be expected to create or substitute for such a structure.

A third principle is that international competitiveness for our banking institutions which is perceived by some to require the expansion of banking organizations into new nonbanking activities, not be purchased at the price of destroying the integrity of our domestic capital markets. The members of SIA do not fear competition with commercial banking organizations in the securities business if such competition is on equal terms, but we do not want to compete against Uncle Sam.

If banks are going to engage in the same activities as nonbank-affiliated securities firms, but with access to cheaper funds, specialized accounting rules, a "too big to fail" aura, and exemptions from the legal requirements applicable to broker-dealers, they will inevitably dominate and eventually monopolize the capital markets just as they do in Germany. It should not be taken on faith that moving our financial services industries in the direction of the universal banks of Germany will produce the beneficial effects for international competitiveness that are claimed by universal bank advocates.

SIA's proposal for financial services restructuring is designed to permit banking organizations that desire to do so to engage synergistically in credit, securities and security-related activities, provided Uncle Sam does not support those activities and the taxpayer is not at risk. But a recent study by the Center for European Policy Studies notes that German universal banks are not especially profitable next to foreign banks. Japanese banks, which are precluded under article 65 of the securities and exchange law of that nation from engaging in the securities business, just like our banks, are by far the most competitive internationally. Let me note, parenthetically, that rumors of the demise of article 65 are greatly exaggerated. Japanese bank regulators, bankers and investment bankers with whom I have discussed the issue lately have asserted uniformly that no changes will be made to article 65 unless and until Glass-Steagall is repealed in this Nation.

The strengths of our capital markets and the reason they are more innovative than any other of the world's capital markets is the diversity of their participants. According to the study I just mentioned, German universal banks have stiffled the growth of German's equity market and have reduced financing options in that country to the point that Germany has become one of the largest importers of financial services.

Fair competition is not just a matter of parochial concern for the securities industry, but the essence of the integrity of our free markets. Care must be taken that Government support be confined to the core banking activities for which it is intended, and not used in nonbanking activities to increase taxpayer risk. As banking organizations begin to resemble other financial services providers more and more, their special advantages likewise should be neutralized insofar as their nonbanking activities are concerned.

There are many, many issues to be addressed. The written statement filed with the committee goes into some detail about various of these issues and includes SIA's proposal for a legislative solution to some of them. The debate about these issues will be a vigorous one.

We thank the committee for the opportunity to add our thoughts to the debate and look forward to the opportunity to assist in any way we can in the formulation of a structure that addresses these critical concerns.

Thank you.

[The complete statement of Robert N. Downey follows:]

COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS
UNITED STATES SENATE

HEARING ON THE NEED FOR LEGISLATION WITH RESPECT TO FINANCIAL SERVICES
APRIL 3, 1990

STATEMENT OF THE SECURITIES INDUSTRY ASSOCIATION ON THE FUTURE OF FINANCIAL SERVICES: THE FEDERAL DEPOSIT INSURANCE SYSTEM, IMPROVING BANK REGULATION AND A FRAMEWORK FOR THE 1990s

PRESENTED BY

ROBERT N. DOWNEY
CHAIRMAN
SECURITIES INDUSTRY ASSOCIATION

EXECUTIVE SUMMARY

The nation's taxpayers over the next several years will be paying out more than 200 billion dollars as the result of misjudgments about what federally insured institutions should be permitted to do and unwarranted optimism about the ability of regulators and regulations to control risk. The thrift industry bailout makes it abundantly clear that our existing system of federal deposit insurance is fundamentally flawed.

The defects in the current system can be traced to two primary sources. The foremost problem is the "moral hazard" that has been generated by the juxtaposition of government insurance of banking liabilities with increased deregulation of banking assets. A second, related problem is the evolution of the "too big to fail" doctrine, which has expanded government backing beyond the stated insurance limits for deposits to all of the creditors of a banking organization.

The most obvious impact of the "moral hazard" is on the pocketbook of the American taxpayer. Another important ramification of the "moral hazard" is that it distorts competition in the financial services sector. When banks get credit irrespective of their creditworthiness, they have an overwhelming advantage over free market competitors. This may not have been much of an issue when banks were confined to traditional banking activities such as deposit-taking and lending, but as their nonbanking powers expand into securities and other financial services provided by firms that do not require or enjoy government support, unfair competition becomes manifest and a matter of great concern.

Many of the current proposals for deposit insurance reform seek to address the "moral hazard" issues by tinkering with the level of coverage. Some would drop the nominal insurance limits, others would apply the limits on a per person, rather than per account, basis, still others would impose "haircuts" or deductibles on deposits over $100,000 and, amazingly, some would provide 100 percent coverage for all bank accounts. Those proposals which would legislatively repudiate the too big to fail doctrine and otherwise eliminate federal taxpayer subsidies to large depositors and other bank creditors who are not in need of special protections make sense. But to the extent they seek to reduce taxpayer risk merely by reducing coverage levels, such proposals ignore the principal lesson of the thrift debacle. The hundreds of billions of taxpayer dollars that will need to be expended on the thrift industry bailout involves accounts that, in the majority of cases, did not exceed insurance limits.

The key to meaningful deposit insurance reform is simple. If the federal government is going to be responsible for the liabilities of a banking organization, it must also be responsible for the activities of that banking organization. This means, to the maximum extent feasible, eliminating unnecessary risk from such activities. Unnecessary risk consists of activities that carry a high level of risk and that are being performed competently in the private sector, without government support. In effect, risky "wholesale" financial services constitute unnecessary risk. As a general matter, it is worth examining the extent to which activities that do not serve the retail depositor or borrower belong in a federally insured bank.

Deposit insurance reform must start from the premise that it is unacceptable for taxpayers to be asked to shoulder risks from bank activities that can be and should be conducted without government support. Any structure that permits the conduct of wholesale securities and securities-related activities within a banking organization must simultaneously ensure that the organization's federally insured banks are in no way implicated in such activities. Such a structure must, in the strongest and most unambiguous statutory terms, isolate federally insured banks from their affiliates engaged in such risky wholesale activities. As the costly thrift experience demonstrates, primary reliance cannot and should not be placed on regulators to protect the safety and soundness of federally insured banks.

Equally important, no structure can adequately protect federal deposit insurance so long as regulators continue to extend the "too big to fail doctrine" to bank affiliates. If bank affiliates are permitted to engage in risky wholesale activities that the private sector is already competently performing, the losses and failures of such affiliates must be privatized. Any deposit insurance reform legislation must ensure that the federal taxpayer is protected and fair competition promoted by specifying that federal deposit insurance funds cannot be expended on behalf of entities that are not involved in insured deposit-taking. Fair competition is essential to the integrity of our financial markets.

In addition, regulatory harmonization and consolidation is needed in several areas. Where the federal taxpayer is at risk, federal standards should control. State-chartered institutions which elect to have federal deposit insurance should have no broader powers than federal law permits. If there are to be different levels of risk for different classes of insured financial institutions, federal decisions should govern the distinctions.

Another area of regulatory disharmony is the regulation of securities activities. The securities activities of banking organizations should be regulated no differently than the securities activities of nonbanking organizations. It follows that, for reasons of fair competition essential to the integrity of the securities markets and functional regulation, as well as to remove unnecessary risk from federally insured institutions, all securities activities of banking organizations, including all agency activities such as private placements, should be conducted in separate nonbank affiliates that are registered as brokers and/or dealers with the SEC. For similar reasons, all securities-related activities (e.g., speculative foreign exchange) should be conducted in separate nonbank affiliates.

There have been some recent suggestions by regulators that it would be desirable to extend the bank holding company model of regulation to securities firms that are not part of banking organizations. These suggestions raise fundamental questions about the reasons for, and appropriate scope of, regulation. There is danger in putting too much faith in the power of regulators, however competent and diligent. Regulators cannot eliminate risk from businesses such as the securities business, no matter how many affiliates they have jurisdiction over or how closely they attempt to micro-manage. Dealing with risk by throwing more regulation at it provides no more than a false sense of security that is ultimately detrimental to the protection of the public.

This is not to say that there is no purpose in regulation of the securities business. Of course there is. The SEC plays a vital role in implementing legal requirements of fair disclosure and other rules of fair conduct in the business. But its role is essentially that of an umpire or referee, blowing the whistle from the sideline but letting market forces work. The SEC's mode of regulation leaves the market as the primary and ultimate disciplinarian. By contrast, the highly-regulated and controlled banking sector has, through regulator intervention, lost much of its market discipline. Such regulation has little to recommend it in the securities business.

The differences between the regulatory approach currently applicable to the banking system and the approach applicable to nonbank-affiliated securities firms are fundamental. This different kind of regulation in the securities industry has engendered a more self-reliant, and, from the taxpayer point of view, safer, financial sector.

What is needed is not "more" regulation, but increased privatization of financial services. Government regulation and intervention should be focused on protecting small and unsophisticated depositors. At the same time, efforts should be made to minimize any remaining systemic risk.

One example of how privatization can lead to a diminution of government support of the payments system. One of the bastions of the "too big to fail doctrine" is that the failure of a major financial institution that is an intermediary in the payments system might spread to other members of the payment system chain. But such a chain reaction is not inevitable. The 140 members of the CHIPS network, which is operated by the New York Clearing House Association, recently agreed to provide $4 billion in collateral that will ensure settlement finality and insulate the system from the effects of a major bank failure. Similar methods that would use private participant funds to support the large dollar payments system in the event of a participant's failure could and should be instituted for the Fedwire system. A proposal by New York Federal Reserve Bank President Corrigan addresses this possibility.

Proposals such as the Proxmire bill passed by the Senate, the Financial Services Council bill, the Corrigan bill and the "narrow bank" bill each constitute legitimate and helpful contributions to the debate about new powers. But the proper balance between safety and soundness and providing banking organizations their desired opportunity for "synergy" is an elusive one.

SIA believes that its Plan for Taxpayer Protection and International Competitiveness reconciles the tensions among the objectives of expanding bank powers, protecting the taxpayer, preserving the integrity of our domestic markets through continued fair competition and improving the international competitiveness of U.S. financial organizations in foreign markets. The cornerstones of the Plan are: first, distance all securities and securities-related activities (e.g., speculative foreign exchange, commodities trading) from federally insured banks; second, permit banking organizations to form uninsured (or privately insured) financing companies that can accept wholesale deposits and make commercial loans; third, permit such financing companies to own securities subsidiaries in which all of the banking organization's wholesale securities activities and securities-related activities are conducted; fourth, permit full interaction between such securities subsidiaries and the financing company; fifth, institute specific "no contact" rules prohibiting interaction between the banking organization's federally insured banks and its financing company/securities subsidiary group; sixth, give the financing company/securities subsidiary group and nonbank-affiliated broker-dealers access on equal terms to the large dollar payments system and, in times of generalized liquidity crisis, to the Federal Reserve window on a fully collateralized basis; and seventh, permit SEC-registered brokers to establish consumer banking subsidiaries.

INTRODUCTION

The Securities Industry Association is honored to be included in this most important series of hearings and is grateful on behalf of its members and the citizens of this country that the Committee is undertaking this review.

The 1990 Chairman of SIA is Robert N. Downey, a partner of Goldman, Sachs & Co., an international investment banking firm with its principal office in New York City. Edward I. O'Brien, the full-time president of SIA, is headquartered in New York City. Marc E. Lackritz, the full-time executive vice president of SIA, is head of SIA's Washington office and coordinator of all of its activities in Washington dealing with legislation and regulation. Each of them is eager to provide his assistance and the resources of SIA to the Committee in the consideration of these critically important matters.

SIA represents over 600 firms active in the securities business. SIA's members range from large firms engaged in a full spectrum of national and international securities and securities-related activities to small firms engaged exclusively in retail brokerage. Its members are located throughout the United States and Canada. SIA member firms account for more than 90 percent of securities entities in North America.

The focus of these hearings is on our commercial banking system. The members of SIA do not pretend to be banking experts. However, the members of SIA are borrowers from banks and, increasingly, they find themselves in competition with banks as bank regulators permit more and more commercial banks entry into the securities business. Many members of the securities industry believe that such regulator-approved entry of banks into the securities business without benefit of new legislative authorization or direction is neither wise for the country nor fair for the securities industry. If banks are to expand into nonbanking areas, such expansion must be done in a way that is wise and fair.

The regulatory expansion of bank powers that is underway at present is unwise and unfair because of the special position of commercial banks, surrounded as they are by a web of regulatory support which has given rise to the concept of at least some large banks being "too big to fail." The concept goes back at least into the 1970s and grows out of the protection offered by federal deposit insurance.

As the thrift bailout has shown, if deposit insurance is asked to protect against too much risk, staggering costs to the taxpayers may follow when the insured claims far outstrip the assets of the deposit insurance fund. The activities of a bank that is too big to fail or an institution that is heavily funded with insured deposits are supported by, and implicate, the resources of Uncle Sam and American taxpayers. Recent amendments to our banking laws have enshrined the phrase "insured bank"; it is officially recognized that an insured bank is more than a bank with insured deposits. Creditors of such federally insured institutions have good reason to believe that they will be bailed out no matter what happens to the bank. For this reason, banks derive borrowing strength courtesy of the U.S. government, an advantage which, if used to support activities outside of banking, creates unfair competition for nonbanking organizations.

SIA applauded the decision of Congress in FIRREA to commission studies of the federal deposit insurance system. At a time when Congress and American taxpayers are facing bills of upwards of $200 billion because of deregulation backed by federal deposit insurance, it would appear only prudent that any expansion of bank powers be deferred until after Congressional action on deposit insurance reform. The Honorable Henry B. Gonzalez, Chairman of the House Committee on Banking, Finance and Urban Affairs, has written to the Federal Reserve Board urging the Board to defer its proposed authorization of bank securities affiliates' entry into the stock markets as underwriters and dealers pending Congressional action on the deposit insurance studies. SIA also has urged the Board to await the outcome of such studies. Thus far, the Federal Reserve Board has shown no inclination to defer equity underwriting powers for banking organizations.

Members of SIA are concerned that the nation's taxpayers over the next several years will be paying out hundreds of billions of dollars as the result of misjudgments about what federally insured institutions should be permitted to do and unwarranted optimism about the ability of regulators and regulations to control risk. The nation cannot afford a repetition of such a disaster. At the same time, concerns are being raised about the competitiveness of our financial institutions in foreign markets. Our country's banks feel a need to expand into nonbanking businesses. They point to alternative financial industries, such as the securities industry, which have invented less costly financing techniques to replace more expensive bank lending. As banks seek to diversify into activities outside their traditional depository and lending functions, SIA believes the government support they receive should be neutralized. Many bank activities can and should be "privatized." Also, as banking organizations become more like other financial services providers, some of the advantages banks enjoy which by custom have been confined to banks might, on examination, be perfectly appropriate for nonbanks.

SIA is pleased that so many of the fundamental questions that need to be addressed are the subject of these hearings:

> What is the purpose of federal deposit insurance? How can we achieve that purpose with acceptable risk to the federal government and the American taxpayer?
>
> What can we reasonably expect from regulation in the area of financial services -- what or whom do we want to protect and how reasonable is it to rely upon regulation working effectively? Do we expect the impossible from our regulators? How are the regulatory structures in our financial sector working?
>
> What structural changes should be made for the future? If there are to be new nonbanking powers for commercial banking organizations, what should the framework be? What safeguards should there be for vital parts of our financial system? What policy questions are presented in establishing a new structure? Do we as a matter of policy want to socialize, in effect, our commercial banking industry, as is occurring in the thrift industry as a consequence of failed policy?

Meaningful reform proposals must deal effectively and comprehensively with these matters and must reconcile the public policy objectives of preserving confidence in our financial system, promoting U.S. international competitiveness, protecting American taxpayers and preserving fair competition in our U.S. financial markets.

The conflicting objectives to be reconciled include:

1. Protecting American taxpayers from the possibility of a taxpayer bailout of the commercial banking industry similar to that of the thrift bailout:

   What is the purpose of a bank? What kinds of activities should the U.S. government be supporting? Can more market discipline be brought to bear on operations of commercial banking organizations? Can risks presently undertaken within federally insured banks (e.g., speculative foreign exchange and overseas securities activities of federally insured bank branches) be eliminated by moving such activities to separate uninsured affiliates?

2. Readying American financial institutions for increasing international competition in financial services:

   If more flexibility is desired by commercial banking organizations to compete in other nations, how can credit and securities functions be allowed to operate in tandem without increasing taxpayer risk? What kind of regulatory framework will work best for such "synergistic" activity?

3. Preserving the integrity of the U.S. financial markets:

   Our capital markets are the world's finest. Fair and open competition is essential to preserving the integrity of our financial markets. Germany's underdeveloped markets have often been contrasted to ours. A recent European study laid the blame for the state of Germany's capital markets on Germany's universal banks. Our tradition favoring broad and diverse choices for financial services, our strong antimonopolistic feelings and our preference for private, non-governmental financial institutions all have to be examined in light of how other nations operate. What would be lost or gained by modeling our capital markets after those of others? What would be gained or lost by extending banklike regulation to these markets? If banks are allowed more securities powers, what banklike advantages should be made available to nonbanks?

4. Increasing investor protection in the United States by requiring that all securities activities be carried out by broker-dealers registered with the SEC:

   The time is long past for eliminating bank exemptions from the securities laws. The most logical way of making this change is to require the conduct in separate affiliates of federally insured banks of all activities which if carried on by nonbanks are subject to the various securities laws, including those dealing with collective investments.

SIA's perspectives on the subjects of these hearings are derived in part from the roles of SIA members who are borrowers from banks, investment bankers to banks and sellers of investment securities to banks. SIA members know the risks and demands of their own business. They have been observers of paternalistic bank regulation while experiencing their own, quite different sink-or-swim form of regulation. Measured in taxpayer cost, there is no question that the kind of market-driven regulation that builds self-reliance is preferable. Failures are bound to occur in any business. Who suffers the consequences, who picks up the costs? SIA believes that rethinking governmental support for present and proposed commercial bank activities is long overdue.

SIA recognizes the complexity of these questions. In the 100th Congress a great deal of effort was expended to find a sensible answer to the issues involved in enlarging bank securities powers. It is interesting to note that as the restructuring legislation proposed by the Senate Banking Committee and adopted by the Senate moved through the House Committee on Banking, Finance and Urban Affairs and the House Committee on Energy and Commerce, the structure became more conservative. The thrift crisis which fully occupied the banking committees of both houses in the first year of the 101st Congress evidences the wisdom of such caution.

Some aspects of these questions have been addressed by SIA in recent testimony before the Securities Subcommittee of this Committee on March 6, 1990. This Statement, while self-contained, builds on that testimony which addressed the condition of the securities industry and its future.

FEDERAL DEPOSIT INSURANCE REFORM

The money pit that the thrift industry bailout has become makes it abundantly clear that our existing system of federal deposit insurance is fundamentally flawed. The defects in the current system can be traced to two primary sources. The foremost problem is the "moral hazard" that has been generated by the juxtaposition of government insurance of banking liabilities with increased deregulation of banking assets. A second, related problem is the evolution of the "too big to fail" doctrine, which has expanded government backing beyond the stated insurance limits for deposits to all of the creditors of a banking organization.

"Moral Hazard" and its Consequences

The "moral hazard" inherent in today's deposit insurance system has been described by numerous observers, perhaps most vividly by the reviewer of a study of the thrift disaster (Paul Zane Pilzer with Robert Deitz, Other People's Money, Simon & Schuster; 1989) in the Economist (December 2, 1989):

> [The] blame lay not merely with . . . deregulation, but with the fact that Congress had deregulated only one side of the thrifts' balance sheets. They were given great freedom on the asset side in the sort of loans they could make or securities they could buy, while the risk of loss on the liabilities side, to those who had provided deposits, remained underwritten by the federal

> government. . . . If they made money, thrift owners collected the profits. If they lost it, Uncle Sam ate the loss.

Gerald Corrigan, President of the Federal Reserve Bank of New York, in a speech earlier this year succinctly dissected the "moral hazard" into three components, summarized as follows:

1. The existence of deposit insurance encourages banks to take on more risk than they otherwise would.
2. Banks are not subject to the creditworthiness tests that are applied to other financial services providers by investors.
3. The Federal Deposit Insurance Corporation (with its limited funds) but with the assistance of the unlimited funds of the Federal Reserve System chooses to prop up a troubled bank with financial support instead of liquidating it and paying off only insured accounts, thereby validating the credit nonchalance of bank owners and depositors; the banks continue as an entity and all of the creditors are protected.

The most obvious impact of this "moral hazard" is on the pocketbook of the American taxpayer. Unfortunately, the taxpayer doesn't quite comprehend it yet. $200 billion is too big a number; even the estimate of $2,000 per taxpayer (possibly more) doesn't register. Like the national debt, the number is just too big.

What will perhaps become clear to the average taxpayer is that this monumental disaster is big enough to eat up all of any "peace dividend." Two hundred billion dollars exceeds the annual budget deficit; interest alone on that amount will exceed $15 billion per year. Paying that money will crowd out many, many worthwhile projects--$15 billion annually for 20 years would do wonders for infrastructure needs in this country, health care, education and the environment. The point is that "deregulation" of government-controlled and backed financial institutions has turned out to be one of the greatest financial disasters in the history of the United States.

Another important consequence of this "moral hazard" is the destruction of market discipline: When banks can obtain credit irrespective of their own creditworthiness, they have an overwhelming advantage over free market competitors--in whatever the line of business is. This may not have been much of an issue when banks were confined to traditional banking activities such as deposit-taking and lending, but as their nonbanking powers expand into securities and other services provided by firms that do not require or enjoy government support, the creditworthiness derived from government support becomes a major unfair competitive advantage of great concern.

Reducing Deposit Insurance Coverage

Most of the current proposals for deposit insurance reform seek to address the "moral hazard" issues by tinkering with the level of coverage. Some proposals would drop the nominal insurance limits from $100,000 per account to a lesser figure. Others would keep the $100,000 limit, but apply it on a per person, rather than per account basis. Still others would keep nominal limits on insurance coverage but impose "haircuts" or deductibles on deposits over $100,000. Amazingly, some proposals would provide 100 percent coverage for all bank accounts; the reasoning is not without logic, however dangerous it would be: the "too big to fail" doctrine leaves smaller banks, which may not benefit from the doctrine, at a competitive disadvantage versus larger banks.

Some of these proposals are wrong on their face. "Reforming" deposit insurance by codifying the "too big to fail" doctrine would simply increase taxpayer exposure; what is now theoretically discretionary would become mandatory, increasing "moral hazard" and unfair competitive advantage. The same is true of proposals that large depositors be limited to a contractual right to "only" 90 percent or 95 percent of their deposits over $100,000 if their bank fails. How can market discipline be improved if depositors who now do not have a legal claim for deposits over $100,000 are given a flat guaranty of 90 or 95 percent of such amounts?

Such proposals must be evaluated in the context of the purposes of federal deposit insurance. Our deposit insurance system was enacted in 1933 to protect small and unsophisticated depositors, who needed a safe haven for their savings and lacked the ability to evaluate the creditworthiness of particular financial institutions. There was a psychological component as well: restoring that depositor's confidence in his bank. So, in addition to safeguarding the savings of small depositors of failed banks, deposit insurance provided the small depositor, who was unable to distinguish between healthy and troubled banks, sufficient confidence to leave his money in his bank in hard economic times, thus adding stability and liquidity to the banking system. As evidenced by the initial modest insurance limits, deposit insurance was not intended to protect large, sophisticated depositors from the consequences of their mistaken credit judgments. Therefore, current proposals that would have the effect of legislatively expanding the limits of deposit insurance to protect large depositors are unnecessary, dangerous and at odds with the purpose of such insurance.

Proposals which would legislatively repudiate the too-big-to-fail doctrine and otherwise eliminate federal taxpayer subsidies to large depositors and other bank creditors who are not in need of special protections make sense. But to the extent they seek to reduce taxpayer risk merely by reducing coverage levels, such proposals ignore the principal lesson of the thrift debacle.

The hundreds of billions of taxpayer dollars that will be expended on the thrift industry bailout involve accounts that, in the majority of cases, did not exceed insurance limits. To be sure, had there been lower insurance limits taxpayer liability might have been reduced to some lesser number of billions. In SIA's view, the taxpayer exposure arose not because the limits were too high, but because there were inadequate restrictions on the use of federally insured funds by federally insured institutions.

Eliminating Unnecessary Risk

The key to meaningful deposit insurance reform is simple. If the federal government is going to be responsible for the some or all of the liabilities of a banking organization, it necessarily must be concerned with--because it may wind up being responsible for--the activities of that banking organization. Common sense and unpleasant experience dictate that, to the maximum extent feasible, unnecessary risk should be eliminated from federally insured banks. Put another way, what activities should the federal government be supporting with its insurance funds and taxpayer backup anyway?

Proposals for restructuring commercial banks into so-called "narrow banks" would remove virtually all risk from federally insured banks by converting them, in effect, into high-quality money market funds. While this approach is not without merit, there are certain services which, though bearing risk, are best provided by banks and which the federal government has an interest in supporting. "Retail" mortgage or consumer loans to individuals are examples of traditional banking activities which, though not without risk, serve an important public policy function. And it makes sense that a retail depositor should have access to retail loans within the same institution.

What then is unnecessary risk? Over time it probably will have to be redefined, a continual process. However, unnecessary risk can be said to involve activities which carry a high level of risk and which are being performed competently, efficiently and competitively by the private sector without government support. Arguably, unnecessary risk also includes activities which do not serve the retail depositor or borrower. Clearly, risky "wholesale" securities services involve the kind of risk in which it is not necessary for a federally insured bank to participate.

Congress, in creating the federal deposit insurance system in 1933, recognized the need to eliminate unnecessary risk by simultaneously enacting the Glass-Steagall Act, which was intended to distance federally insured banks from the risks of most securities activities. Congress by legislation created limited exceptions to the general prohibition on bank involvement in securities activities for underwriting and market-making in U.S. securities and municipal full faith and credit obligations. At the time, these exceptions were consistent with the "no unnecessary risk" principle: The exceptions involved high-grade debt instruments backed by the full faith and credit of federal, state and local governments. Also, authorizing banks to distribute government securities promoted public policy objectives in an era when a strong independent securities industry had not yet fully developed.

When Congress enacted Glass-Steagall and its limited exceptions, it could not envision the financial markets of the 1990s. Much has changed. Interest rate volatility has increased the risk of dealing in formerly "safe" bank-eligible securities; individual banks have lost millions of dollars (some hundreds of millions of dollars) trading and speculating in U.S. Treasury obligations and other bank-eligible securities. And the public policy rationale for burdening banks with such risk has disappeared; there is now a strong, nongovernment-supported securities industry that has created an efficient and reliable market for public, as well as corporate, securities.

Foreign exchange dealing is another example of an activity carried on by federally insured banks that poses an unnecessary risk to the federal taxpayer. According to the Bank for International Settlements, average daily foreign exchange trading by banks worldwide in 1989 exceeded a trillion dollars. Banks trading for their own account, as opposed to providing intermediary services for customers, accounted for about 87 percent of the gross foreign exchange volume. Foreign exchange trading by U.S., British and Japanese banks accounted for approximately 60 percent of the volume. Thus, on any given day, U.S. banking organizations expose federally insured deposits to the risks inherent in principal dealing in hundreds of billions of dollars of foreign exchange.

One more example of unnecessary risk directly carried on and funded by a federally insured bank: the Comptroller of the Currency, in a letter dated December 19, 1989 that was recently released, approved the establishment by a subsidiary of a national bank of a commodities pool which will trade, invest in and hold foreign currency, gold and silver futures and options contracts. Shares in the commodity pool will be sold to customers of the bank by the bank. Under the Comptroller's ruling, the bank will "limit" its investment in the commodity pool to five percent of its primary capital. This will be the first commodities pool operated by a bank in the United States, at least since 1933. According to a bank executive quoted in the American Banker (March 19, 1990), "[t]he real appeal is the Chase name. I could probably name 100 [other operators] and you would never have heard of any of those people or any of those firms, but Chase, well, yeah, people say: 'I'll give my money to Chase.'" The American Banker observed that such activities involve "high risks."

One wonders whether there is any reason to permit continued participation by federally insured banks in such risk-filled activities. There are certainly strong reasons, involving fair competition and taxpayer protection, to divorce such activities from federally insured banks. Deposit insurance reform must start from the premise that it is unacceptable for taxpayers to be asked to shoulder risks from bank activities that can and should be conducted without government support.

Developing a New Structure

The tougher question is how far to distance federally insured banks from such unnecessary risks. There can be no question that the safest course would be to prohibit such activities anywhere within a commercial banking organization owning federally insured institutions, on the grounds that, in times of great stress, legal niceties such as separate affiliates and "firewalls" are not the surest way to prevent the flow-back of risk to the federally insured units of the banking organization. SIA advocated such a position for many years and many in Congress remain firmly convinced that this is the best way to protect taxpayers.

However, even though the greatest financial powers in the world, the United States and Japan, have attained their positions under Glass-Steagall and its Japanese analog, Article 65 of the Securities and Exchange Law, the banking industry has persuaded many that American banking organizations must be granted broadened securities powers to remain internationally competitive. SIA has some skepticism, especially in light of current conditions, that the path to salvation for our banking industry runs through the securities business. However, if banking organizations are to become full participants in the securities business, SIA has some thoughts and concerns about the structure for such participation.

To accommodate participation by banking organizations in the securities business, deposit insurance reform must include a structure that separates "wholesale" securities and securities-related activities from federally insured banks, while permitting the conduct of such activities elsewhere within the commercial banking organization. Taxpayer protection dictates maximum separation between a banking organization's wholesale securities and securities-related activities and its federally insured banks.

At the same time, to achieve the "synergies" that American bankers say they must have to be competitive internationally, the new structure can be designed to permit banking organizations to offer combined deposit-taking, lending and securities services at the commercial, institutional and governmental level, but without involving any affiliated federally insured banks.

SIA believes that there is an approach which can reconcile the apparently inconsistent objectives that are being discussed:

- reducing risk to the federal deposit insurance system and American taxpayers;

- greater participation of commercial banking organizations in nonbank financial services;

- "synergy" for commercial banking organizations in deposit-taking, credit and "wholesale" securities and securities-related activities;

- continued fair competition in nonbank financial activities at home and abroad without distortion by unfair bank advantages;

- greater protection for investors through SEC supervision of the securities activities of commercial banking organizations; and

- the continued possibility for American securities firms to remain independent of affiliations with federally insured commercial banks if they wish to do so and concentrate on what they do best.

The resolution of these issues will affect SIA's members both as competitors in the securities business and as taxpayers. For that reason, SIA has developed a plan which it believes will serve to achieve the public policy objectives discussed earlier as well has to harmonize the divergent interests of the banking industry, securities industry, depositors, investors, taxpayers and the federal government. A detailed description of the SIA Plan for Taxpayer Protection and International Competitiveness is set forth in the section of this Statement entitled "Reconciling New Bank Powers With Bank Safety and Soundness and Fair Competition."

The Need for Statutory Restraints

Before getting into details about such a structure, however, some general points need to be made about developing a structure that permits wholesale securities and securities-related activities to be conducted within a banking organization. First, such a structure must, in the strongest and most unambiguous statutory terms, isolate federally insured banks from their affiliates engaged in risky wholesale activities. As demonstrated by the costly thrift experiences, primary reliance cannot and should not be placed on regulators to protect the safety and soundness of federally insured banks.

There are those who claim that the thrift disaster occurred not because Congress and state legislatures permitted federally insured savings institutions to "diversify" into new risk-laden activities but because thrift regulators did an inadequate job of monitoring the activities of their regulated institutions. To be sure, thrift regulators could have done a far better job and the cost to taxpayers may have been somewhat less. But in all fairness, it is highly unlikely that any regulator, irrespective of quality or quantity of staff, could have prevented what happened. Unlike other countries, our federally insured institutions number in the thousands. The number of transactions conducted at any one institution, let alone system-wide, on any one day is not susceptible to detailed human supervision by a corps of regulators. With recent technological advances and the increasing complexity of transactions, money and securities move around so quickly that it is unrealistic to expect regulators to keep pace, even in the best of times. And of course, in these days of budget deficits, when many budget changes have to be "revenue neutral," hiring and retaining competent regulators is difficult.

While regulators may assist the Congress in exercising responsibility over federally insured institutions, they cannot be expected to do the impossible. Amorphous, fact-specific concepts such as "arm's length transactions" cannot substitute for clear prohibitions that eliminate types of transactions involving direct or indirect support by federally insured institutions of activities they have no business supporting. This means putting into place strong, self-executing statutory "no-contact" rules between the federally insured bank and such affiliates.

Limiting the "Too Big to Fail" Doctrine

Equally important, no structure can protect federal deposit insurance if bank regulators continue to extend the "too big to fail doctrine" to bank affiliates. If bank affiliates are permitted to engage in risky wholesale activities that the private sector is already competently performing, the losses and failures of such affiliates must be privatized. Since the intervention of bank regulators to hold the creditors of the Continental Illinois bank holding company harmless as well as the bank, it is understandable that the perception has spread that nonbank affiliates indeed may be under the federal deposit insurance fund protection blanket as well.

The "too big to fail" doctrine, which massively increases the burden on the federal government and American taxpayers and destroys market discipline, is one of the biggest examples of creation of unnecessary risk. As Gerald Corrigan noted in a recent speech:

> [L]et me say that I am mindful of the widespread view that some banks are too big to fail. That view has very troubling implications and does not jibe with reality. After all, a number of large banks have failed and in the process managers and shareholders have been wiped out. In other cases, market and regulatory pressures have forced troubled large institutions into major restructurings, shrinkages and the need to raise large amounts of new equity type capital despite sizeable dilution of existing shareholders.

Of course, insofar as creditors are concerned, their concern is whether their deposits or other loans will be repaid, not whether shareholders and managers are protected. To creditors, a bank is "too big to fail" if they get their money back regardless of the size of their loan to a bank and regardless of the bank's condition. This existing regulatory doctrine magnifies the governmentally conferred credit strength and competitive advantages of banks.

Mr. Corrigan is of the view that market discipline and the federal safety net are best served by a policy of "constructive ambiguity" about whether and when bank regulators will intervene to prop up a failing bank. Perhaps such "constructive ambiguity" can be justified with respect to federally insured banks, if their activities are limited to those that promote clear public policy objectives of federal deposit insurance, such as supporting institutions that service retail depository and credit needs. But there is nothing "constructive" about applying the "too big to fail" doctrine to support bank affiliates engaged in activities far removed from such purposes. Any deposit insurance reform legislation should ensure that the federal taxpayer and fair competition are protected by removing such "ambiguity" and specifying that federal deposit insurance funds cannot be expended on behalf of entities that are not themselves federally insured institutions. Further, activities which are not at the vital core of what a federally insured bank needs to do, particularly if they involve significant risk, should be shifted to such nonbank affiliates.

IMPROVING THE REGULATORY STRUCTURE

The balkanization of bank regulation has been discussed for decades. The Vice Presidential Task Force of a few years ago proposed various changes. The thrift bailout legislation has produced some. There is a broad array of financial institutions which have the benefit of federal deposit insurance, and a broad array of regulators monitoring such institutions. Such widespread distribution of regulatory functions does not appear to have been conducive to efficient or cohesive development of policy. For example, the Federal Reserve Board and the Comptroller of the Currency clearly do not see eye to eye on activities which should be carried on in a federally insured national bank.

Common Standards for Federally Insured Institutions

Again, sticking to basic principles, where the federal taxpayer is at risk, federal standards should control. State-chartered institutions which elect to have federal deposit insurance should have no broader powers than federal law permits. If there are to be different levels of risk for different classes of insured financial institutions, federal decisions should govern the distinctions.

Distinctions arising from the identity and jurisdiction of the federal regulator also should be eliminated. Capital standards for federally insured institutions should not differ depending upon the regulator. There should not be differing views as is reported to have been the case with the First Options subsidiary of Continnetial Illinois, as to what risks comparable federally insured commercial banks and their subsidiaries should be allowed to incur.

To be sure, new legislation will take care of the "loopholes" that regulators have created or found over the decades. But regulators inevitably will be involved in interpreting, implementing and enforcing statutory mandates. Just as inevitably, splitting up what should be a single regulator's functions results in discrepancies, forum-shopping, turf battles and other impediments to sound regulation. While SIA takes no position as to which of the several existing regulators of federally insured institutions should be designated as primarily responsible for implementing national policy with respect to the activities of federally insured institutions, regulatory consolidation appears to SIA to be a necessary component of deposit insurance reform.

Common Regulation of Securities Activities

There is a glaring regulatory anomaly which concerns bank securities activities. Broker-dealers are, of course, required to be registered with the SEC. However, because of an exemption in the securities laws drafted at a time when the Glass-Steagall Act was thought to mean what it said, banks and their employees need not register as broker-dealers and the SEC has no jurisdiction over their securities activities.

Investors are not protected as they would be were the persons executing securities transactions SEC-registered broker-dealers. Permissive regulatory interpretations and developments such as the proposed implementation of SEC Rule 144A have brought us to a point where a large number of securities transactions may be conducted directly within banks. (SIA has strongly urged the SEC not to permit Rule 144A activities to take place in a bank -- only in a nonbank affiliate which is not a subsidiary of a federally insured bank and which is a registered broker-dealer.) The privileged status of banks as brokers of, and dealers in, securities also leaves securities firms not affiliated with banks, which must comply with the SEC's capital and other requirements dealing with training and qualifications for broker-dealers, at a severe competitive disadvantage.

The securities activities of banking organizations should be regulated no differently than the securities activities of nonbanking organizations. It follows that, for reasons of fair competition and functional regulation, as well as to remove unnecessary risk from federally insured institutions, all securities activities of banking organizations, including all agency activities such as private placements, should be conducted in separate nonbank affiliates registered as brokers and/or dealers with the SEC. For similar reasons, all securities-related activities (e.g., speculative foreign exchange) should also be conducted in separate nonbank affiliates.

Although not the direct subject of this hearing, split regulation in the securities and securities-related areas is a problem as well. In testimony on March 6, 1990 before this Committee's Securities Subcommittee, SIA and other representatives of the securities industry emphasized the importance of establishing the SEC as the single regulator of equities and equity-related markets. SIA also supported giving a single authority such as the Federal Reserve Board the power to set margin requirements for equities and equity-related products. As indicated in that testimony, SIA believes that many of the concerns relating to index arbitrage's contribution to synthetic market volatility and individual investor disillusionment can be alleviated by these two changes.

The Banking Regulatory Model Should Not Be Extended

As indicated above, there is room for improving regulation of institutions, markets and products that are already regulated. There have also been some recent suggestions by bank regulators about the desirability of extending regulation to certain business units that are not regulated. These suggestions raise fundamental questions about the reasons for, and appropriate scope of, regulation, which need to be addressed.

In a widely quoted speech to the New York State Bankers Association in January of this year, New York Federal Reserve Bank President Gerald Corrigan stated that "careful thought" should be given to extending to securities firms, at least to a "limited degree," the model of regulation applicable to bank holding companies. This suggestion would involve regulatory supervision not only of registered broker-dealers, but also of their holding companies and other affiliates. According to Mr. Corrigan, "what underlies my view in this regard is that I remain strongly of the opinion that serious problems in any one part of a financial firm will, inevitably, impact the firm as a whole despite legal separations and regulatory firewalls." Federal Reserve Board Chairman Alan Greenspan testified to the same effect shortly after the Drexel bankruptcy filing, stating that "[t]his experience raises a number of questions about the separation of activities in financial holding companies and about the possible need for an overview of the entire holding company, both regulated and unregulated entities." (American Banker, March 2, 1990).

It is more than a little ironic that these two influential bank regulators, who for years have supported expansion of the powers of federally insured banking organizations to include all aspects of the securities business and have argued that our nation's banks and their federally insured deposits can be insulated from such risks through intra-organizational firewalls and other regulatory devices, should now express concern over the flow-back of risk from affiliates of broker-dealers in the context of securities firms which do not implicate the federal deposit insurance system in any manner. There is also a certain dissonance in the suggestion that regulatory firewalls may be inadequate to contain risk and that the way to deal with this is to consider more banklike regulation.

SIA agrees with Mr. Corrigan in urging that "careful thought" should be given to the idea of extending the model of banking regulation to nonbanking firms. Any such thinking should be extremely carefully done, and should factor in the following considerations: Is the model of regulation that has brought us a $200 billion taxpayer cost for the thrift bailout one we want to export to other financial services industries? Is the model of regulation under which a Bank of New England changes in the course of a few weeks from an apparently solvent super-regional bank to an institution that requires billions of dollars of discount window support to keep going preferable to the one in which the Drexel Burnham Lambert parent company is permitted to fail without systemic disruptions and without taxpayer expenditure? Is a regulatory system under which a federally bailed-out Continental Illinois, with three different bank regulatory agencies watching over it, then bails out its commodities subsidiary in violation of applicable restrictions the panacea for securities firms?

With all due respect to President Corrigan and Chairman Greenspan, SIA believes the answer is no. SIA has great admiration for the Federal Reserve as an institution. However, there is danger in putting too much faith in the power of regulators, however

competent and diligent. Inevitably, broker-dealers and broker-dealer affiliates will fail in the future, just as they have in the past, just as banks and bank affiliates have failed in the past and will fail in the future. There is always the tendency to believe that the best way for a government to deal with risk in the private sector is to supervise it, to control it. But regulators cannot eliminate risk from businesses such as the securities business, no matter how many affiliates they have jurisdiction over or how closely they attempt to micro-manage. It is better to recognize the risks, design a system that will survive individual failures and leave the taxpayer on the bench.

Regulation Does Not Eliminate Risk

Dealing with risk by throwing more regulation at it provides no more than a false sense of security that is ultimately detrimental to the protection of the public. As Vincent Di Lorenzo, a professor at St. John's University School of Law and a perceptive commentator on banking laws, has noted:

> The nature of regulatory monitoring, and the available evidence of its usefulness, indicate that such regulation is inherently incapable of uncovering or avoiding potential hazards, inherently incompetent to correct hazards once uncovered, and counterproductive in effect.
>
> These limitations on the usefulness of regulatory monitoring exist for two reasons: the discretionary nature of evaluative, quality-related restrictions on transactions, and the structural limitations inherent in the oversight process... Evaluative limits aimed at safety and soundness are not only intrinsically indeterminate, but also difficult to apply to particular transactions. Examiners often will be unable to assess the activity at issue due to constantly changing market conditions or the complexity of fixing particular securities' quality or value.
>
> ....
>
> Profit pressures may also lead management to disregard specific regulatory limitations on activities. While one cannot ensure against disregard of the law, the likelihood of disregard increases when a ban of activities is not specific, but discretionary in its nature. In addition, opportunity for abuse increases when a transaction is permissible but for limitations which only internal bank management knows are violated.
>
> The structural limitations of the oversight process is a second reason that regulatory oversight is inherently incapable of avoiding abusive activities. Regulatory oversight is not constant. Banks do not consult regulators with respect to their proposed underwriting activities; regulation is periodic in form and operates to review actions post facto. As a result, an abusive

> practice may endanger a bank's safety and soundness before any regulator has a chance to review it.

Di Lorenzo, Public Confidence and the Banking System: The Policy Basis for Continued Separation of Commercial and Investment Banking, 35 American Univ. L. Rev. 647, 687-689 (1986).

This is not to say that there is no purpose in regulation of the securities business. Of course there is. The SEC plays a vital role in implementing legal requirements of fair disclosure and other rules of fair conduct in the business. But its role is essentially that of an umpire or referee, blowing the whistle from the sideline but letting market forces work. No special accounting rules get invented to hide the truth. The SEC's mode of regulation leaves the market as the primary and ultimate disciplinarian. The highly-regulated and controlled banking sector has, through regulatory intervention, lost much of its market discipline. This kind of regulation has little to recommend it in the securities business.

Drexel's failure, which in some part has prompted these suggestions for adapting the bank holding company regulatory structure to securities firms, itself illustrates the important differences in the two regulatory models. Drexel operated in the market and the market closed it down. No regulator intervention took place to save Drexel or its creditors, and not one taxpayer dime was spent. This "survival of the fittest" doctrine stands in sharp contrast to the "too big to fail" doctrine that undoubtedly would have applied to a similar-sized bank.

As Mr. Corrigan noted in his recent speech, the historic rationale for government regulation of financial services "is the age old concern about systemic risk or the danger that a disruption in one part of the banking and financial system will spread to other parts of the system, thereby undermining confidence generally and inflicting damage on the real economy." There was no such fallout from Drexel's failure. There were no "runs" on other securities firms, no dominos toppled. In large part, this was because the risk inherent in Drexel's operations was privatized risk, and the parties to that risk had no reason for unrealistic expectations about what would happen if Drexel could not make it on its own. Because no one relied on government intervention in their dealings with Drexel, the effects of Drexel's failure were anticipated, private measures were taken in advance to mitigate those effects and no significant, systemic disruptions occurred.

The differences between the regulatory approach currently applicable to the banking system and the approach applicable to nonbank-affiliated securities firms are fundamental. In the case of the securities industry, a different kind of regulation has engendered a more self-reliant, and from the taxpayer's point of view safer, financial sector. There have been no government-financed or taxpayer-financed bailouts -- nor should there be.

The Need to Privatize

The lesson to be learned from the Drexel situation should not be, therefore, that "more" regulation is needed, but that privatization of financial services should be maximized. The paternalistic kind of government regulation and intervention should be increasingly limited to the role of protecting small and unsophisticated depositors and investors. At the same time, efforts should be made to minimize any remaining systemic risk. SIA believes that confidence can be built and systemic risk reduced by privatization. What was a ready answer in 1933 -- deposit insurance to carry the real and the psychological burden of creating confidence -- need not be the answer today.

One example of how privatization can lead to a diminution of systemic risk is the payments system. One of the bastions of the "too big to fail doctrine" is that the failure of a major financial institution that is an intermediary in the payments system might spread to other members of the payment system chain. But such a chain reaction is not inevitable. There are currently two major large dollar payments systems, a governmentally regulated one (Fedwire) and a private one (CHIPS). The primary risk in the payments system is created by provisional settlements that may become unwound in the event a member of the payments system chain fails. The 140 members of the CHIPS network, which is operated by the New York Clearing House Association, recently agreed to provide $4 billion in collateral that will ensure settlement finality and insulate the system from the effects of a major bank failure. Similar methods that would use the funds of private participants to support the large dollar payments system in the event of a participant's failure could perhaps be ultimately substituted for the Fedwire system. Participation in the large dollar payments system does not necessarily depend upon the resources of the Federal Reserve or requiring a "banks only" approach. Even New York Federal Reserve Bank President Corrigan has suggested that a National Payments Corporation with nonbank members is possible. Participation in the large dollar payments system should not be an excuse for excessive government regulation and intervention in private enterprise.

Clearly, privatization will limit taxpayer risk posed by the activities of our financial institutions, thereby limiting the need for government support and regulation. As novel as it might seem, SIA is also suggesting that the extension of banklike regulation to more financial services might increase, not limit, systemic risk. Increased privatization might reduce systemic risk. If, as can be done, some federally supported financial institutions can shed some of the risk they currently are carrying by transferring it to entities not supported by the government, it is difficult to conceive of any good policy reason why this should not be done.

RECONCILING NEW BANK POWERS WITH BANK SAFETY AND SOUNDNESS AND FAIR COMPETITION

Because of the unique status of banks as federally insured and protected organizations, there is a clear downside from a safety and soundness and fair competition perspective to expanding the powers of banking organizations to include the full spectrum of securities activities as well as other financial services that some banks would like to undertake. Advocates for expanded bank powers argue that these risks are outweighed by the necessity of making banks more competitive internationally and increasing the options of domestic financial services consumers.

It is far from clear that moving our banks in the direction of the universal banks of Germany or the state-owned banks of France and Italy will produce such beneficial effects on international competitiveness and domestic choices. Japanese banks, which are precluded from engaging in the securities business just like ours, are by far the most competitive internationally. Indeed, as reported in the Financial Times (March 20, 1990), a recent study by the Centre for European Policy Studies notes that German universal banks are not especially profitable relative to foreign banks. Moreover, according to the study, German universal banks have stifled the growth of Germany's equity market and have reduced financing options to the point that Germany has become one of the largest importers of financial services.

New Powers Require a New Structure

Nevertheless, many changes in the world suggest that reviewing how our financial services system operates is timely. Some assumptions need to be examined carefully. Are there better ways to achieve sound systems? Is government support of banks as warranted today as it perhaps has been in the past? Specifically, as consideration is being given to permitting commercial banking organizations to engage in securities activities and possibly other financial services, can a new structure be created which accommodates this goal without damaging side-effects?

Earlier we have spoken of the need to reconcile conflicting objectives. SIA believes that the plan which it has developed does this better than any other alternative which has been proposed thus far.

Of primary concern is the safety and soundness of the vital core of our banking system. A related concern is that the new structure be one in which the special advantages that commercial banks have in the banking business, such as deposit insurance, special credit arrangements and the aura of government backing, are not used in their nonbanking businesses to compete unfairly against and ultimately drive out firms that lack those advantages. Our financial services markets are the strongest and most creative in the world because of the variety of financial services providers; it would be a sad irony to replace that, in the name of increasing competition, with the German model of few players, few choices and few innovations.

Expansion of powers for commercial banking organizations must be contingent on development of a structure that adequately insulates federally insured depository institutions from risky nonbanking activities, eliminates the need for and aura of government support for such activities and ensures that such banking organizations follow the same rules and share the same advantages and disadvantages as nonbanking organizations engaged in such activities. But the structure must be in place before the new powers are granted. And the structure must have clear, legislative contours.

The SIA Plan for Taxpayers' Protection and International Competitiveness

SIA believes that its "Plan for Taxpayer Protection and International Competitiveness" reconciles the tensions among the objectives of expanding bank powers, protecting the taxpayer, preserving fair competition in domestic markets and improving the international competitiveness of U.S financial organizations in foreign markets. The cornerstones of the Plan are: first, distance all securities and securities-related activities (e.g., speculative foreign exchange, commodities trading) from federally insured banks; second, permit commercial banking organizations to form uninsured (or privately insured) financing companies that can accept wholesale deposits and make commercial loans; third, permit such financing companies to own securities subsidiaries in which all of the banking organization's domestic and international wholesale securities activities and securities-related activities are conducted; fourth, permit full interaction between such securities subsidiaries and the financing company; fifth, institute specific "no contact" rules prohibiting interaction between the banking organization's federally insured banks and its financing company/securities subsidiary group; sixth, give the financing company/securities subsidiary group and nonbank-affiliated broker-dealers access on equal terms to the large dollar payments system and, in times of generalized liquidity crisis, to the Federal Reserve window on a fully collateralized basis (such access need not be at "discount"); and seventh, permit SEC-registered brokers to own "consumer banks."

To achieve these objectives, the SIA plan proposes the creation of a new entity -- an Investment Banking Financing Company (or IBFC) -- as a subsidiary of a bank holding company. The IBFC would not be federally insured, would be authorized to engage in "wholesale" credit and depository activities, and would be permitted to interact fully with subsidiaries engaged in the "wholesale" securities business with no firewalls whatsoever. At the same time, as described below, affiliated federally insured banks would be insulated from contact with the IBFC and its securities subsidiaries.

The IBFC constitutes a departure from the view that automatically assumes that entities involved in deposit-taking and commercial lending must be federally insured. For the reasons discussed earlier in this statement, SIA believes commercial banking organizations should be encouraged to engage in their wholesale depository and credit activities without implicating the federal safety net. Because the IBFC, unlike its affiliated federally insured banks, would be free to interact with the wholesale securities subsidiaries and their customers, the existence of the IBFC would operate as an incentive to banking organizations to move their wholesale credit and depository activities to the IBFC so they could also engage in securities activities with their loan and other credit customers. Equally important, the existence of an entity that provides synergistic wholesale depository and credit services to clients of the banking organization's securities subsidiaries should eliminate "synergy"-motivated pressures within commercial banking organizations to circumvent "firewalls" between their securities operations and their federally insured banking operations. The consequence should be that over time the federally insured bank would progressively rid itself of "wholesale" risk.

Commercial banking organizations desiring to form IBFCs and engage through their subsidiaries in securities and securities-related businesses would be required to conduct all wholesale securities activities within the IBFC/securities subsidiary complex, and would be permitted, but not required, to transfer wholesale credit activities from their federally insured banks to the IBFC in order to benefit from the perceived "synergies" of offering credit, depository and securities services to institutional customers as if under one roof. In effect, a bank holding company's IBFC and its securities subsidiaries would function much like a securities firm that is not affiliated with a bank holding company. In addition to accessing markets and unaffiliated banks for loans directly, the IBFC will have the additional ability to obtain funding through uninsured or privately insured wholesale deposits.

The IBFC structure would give banking organizations the same ability to compete in the securities business as securities firms. At the same time, because the IBFC complex would not have access to its affiliated federally insured banks, federal deposit insurance would not cause competitive distortion vis-a-vis securities firms. To ensure that the federal deposit insurance system is not burdened by losses from activities conducted within an IBFC complex, and to ensure that banking organizations do not obtain unfair competitive advantage from the perception that the IBFC complex is supported by the federal safety net, the SIA proposal would specifically prohibit bank regulators from using federal deposit insurance funds to bail out those nonfederally insured affiliates of commercial banking organizations. Similar nondiscrimination provisions would apply to the Federal Reserve.

To further maximize competitive equality and investor protection, all securities activities conducted within a commercial banking organization would be required to be conducted outside of the organization's federally insured bank units, and the IBFC's securities subsidiaries, as well as other units engaged as securities brokers or dealers, would be required to register as broker-dealers to the same extent that securities firms unaffiliated with banking organizations are required to do so. IBFC securities subsidiaries would be regulated by the SEC as if they were independent of bank affiliation and would adhere to nonbanking accounting requirements.

As an additional component of competitive equality, all broker-dealers, whether or not affiliated with a bank holding company, upon meeting certain credit-related criteria, would, if they so desire, participate directly in the large dollar payments systems and have emergency access to the Federal Reserve window on a fully collateralized basis in times of generalized liquidity crisis. Any number of plans for participation in the large dollar payments systems would work, including the one suggested by New York Federal Reserve Bank President Corrigan. Perhaps completely private large dollar payments systems could be created. As discussed earlier in this Statement, collateralization requirements and other steps taken by the CHIPS payment system suggest that private participants may eliminate systemic risk from the payments system, and thereby mitigate concerns that the operation of, and access to, the payments system inevitable implicates the federal safety net.

Emergency access to Federal Reserve liquidity in times of generalized market crisis would not be available to individual firms with liquidity problems absent a generalized liquidity crisis; thus, a Drexel would not have benefitted from such access in any way. Even at such times of general financial crisis, the Federal Reserve would have the last word on the creditworthiness of the collateral offered. Such access is the one sure way in such times of financial crisis as occurred on October 19 and 20, 1987 to avoid having unaffiliated broker-dealers at the mercy of commercial banking organizations which are direct and complete competitors of theirs in the securities business. The Federal Reserve has had the power to extend such liquidity for decades, but it has never made it directly available to a securities firm. Therefore, SIA's proposal only involves establishing pre-qualification and access procedures for broker-dealers registered with the SEC. Also, the procedures, once in place, may never have to be used. Their mere existence may eliminate the potential for unfair treatment of broker-dealers by commercial banking competitors.

The IBFC can completely substitute for all services that otherwise would be provided by affiliated federally insured banks of a bank holding company; in effect, the government is taken out of the picture altogether, at least insofar as securities and securities-related activities are concerned. Consistent with the substitution provided by the IBFC, the SIA proposal would establish comprehensive legislative "no contact" rules for the IBFC complex and all affiliated federally insured banks.

Under the SIA plan's set of comprehensive, self-executing prohibitions, a federally insured bank will not have any opportunity to assist or participate in commercial, governmental or institutional level securities and securities-related activities of its affiliated IBFC or securities subsidiaries. While such rules may be characterized by banking organizations as inefficient, duplicative, or a nuisance, let there be no mistake: one cannot responsibly allow wholesale securities activities to be conducted within an organization with federally insured units without such strong legal barriers. The existence of the IBFC eliminates all legitimate arguments for interaction between the wholesale securities subsidiaries of a banking organization and their affiliated federally insured banks; any remaining desire for free interaction is, pure and simple, an argument for government subsidization of a commercial banking organization's wholesale securities activities to obtain, among other things, cheaper costs of financing.

The SIA proposal also has consumer components. A federally insured bank in a bank holding company would be permitted to operate a "retail" securities brokerage as a direct subsidiary to carry on consumer retail brokerage activities on an agency basis. The federally insured bank would be permitted to fund the activities of that subsidiary. Securities firms through their SEC-registered brokers would be permitted to own federally insured "consumer banks" to serve consumers at the "retail" level. The consumer bank would be targeted to consumer loans, and unlike presently grandfathered nonbank banks, would be able to grow within the consumer sphere without restrictions. The consumer bank would be precluded from funding or supporting any activities of its parent or any upstream affiliate, but could service the retail consumer customers of the brokerage business.

Details of the SIA Plan

The technical aspects of the Plan are being worked out in legislative language. The details of the Plan are as follows:

1. A bank holding company (BHC) having at least one federally insured bank initially representing at least 50 percent of the assets of the BHC would be allowed to form and own an "investment banking financing company" (or IBFC) which could take uninsured or privately insured deposits (possibly restricted to deposits in excess of $100,000 to avoid misleading the public.) The investment banking financing company would be owned directly by a bank holding company; it in turn could own one or more securities subsidiaries to carry on all of the domestic and foreign securities and securities-related activities of the bank holding company family (collectively referred to as "securities activities"). The securities subsidiaries would be registered with and supervised by the SEC and otherwise to the same extent as they would be if not affiliated with a bank holding company. The IBFC would solicit deposits primarily from businesses, governments and institutions. It could not take large "pooled" deposits consisting of smaller accounts, unless the pooled entity has an existence separate from the deposit (e.g., a pension fund).

2. An IBFC's lending business also would be limited to "wholesale" activities, except that it could assist the funding (but not margin loans) of its securities subsidiaries even though they carry on retail brokerage activities. The IBFC's

commercial, institutional and governmental credit activities would not be limited to transactions or customers involving securities activities.

3. The IBFC and the securities subsidiaries (collectively called a "securities group") would follow generally accepted accounting principles applicable to nonbanking institutions. Letters of credit and other credit enhancements would also be subject to the same accounting rules applicable to securities and other nonbanking firms.

4. The IBFC could work with its securities subsidiaries as it wished: It could supply credit and credit enhancements to the securities subsidiaries and their transactions; it could participate jointly in transactions with such subsidiaries and jointly market or cross-market with them. Reciprocal inducements for a customer of one to deal with the customer of the other would be permitted.

5. All securities activities (underwriting, dealing, placements, and advising in securities) and securities-related activities (e.g., options, futures and speculative foreign exchange) of a bank holding company family, foreign as well as domestic, would be carried on in an IBFC's domestic and foreign securities subsidiaries. A limited exception would be provided for consumer brokerage activities on an agency basis for retail customers, which could be conducted in direct subsidiaries of federally insured banks, but not directly within the bank.

6. All federally insured banks in the BHC family and all non-securities affiliates in the BHC family would be completely prohibited from any contact or dealing with any member of the affiliated securities group; however, the IBFC could obtain equity and credit assistance from its bank holding company or any nonbanking affiliate for itself and its securities subsidiaries as long as the BHC and such affiliate had no credit or credit support outstanding to it or for its benefit from any affiliated federally insured bank or other affiliate that had such credit or credit support outstanding to it. The only exception would be to permit consumer receivables originated by a federally insured bank within a BHC to be sold "wholesale" through an affiliated registered broker-dealer under reasonable conditions.

7. Federally insured banks would continue to operate as full function banks as they have in the past, except for the securities activities to be transferred to the securities subsidiaries in the affiliated securities group and the prohibition of any contact with the affiliated securities group or interaction with clients of the affiliated securities group.

8. The IBFC's broker-dealers would be registered with the SEC and the SEC would have the same oversight and control over such securities subsidiaries as it would if they were independent of a BHC, including setting the capital requirements of broker-dealers. The FRB would cooperate with the SEC in ensuring that no affiliated federally insured bank or other member of the BHC family made prohibited credit or credit support available to its affiliated securities group.

9. The affiliated securities group could pay dividends through the IBFC to the BHC and could make credit available to the BHC for its use and the use of other subsidiaries, including federally insured bank and thrift subsidiaries.

10. A procedure would be provided whereby a broker-dealer subsidiary of an IBFC would have limited direct access to the Federal Reserve window in times of generalized liquidity crisis on a fully secured basis. Borrowing would not necessarily be at "discount." (The Federal Reserve has had the authority for decades to make such liquidity available; therefore, there is no increase in authority involved, only the detailing of a process for such liquidity access in emergency circumstances.) Such a broker-dealer would also be allowed to be a member of the large dollar payments systems maintained by the FRB and might gain access to the Federal funds market. The SEC would act with such a broker-dealer in its qualification process with the FRB; no regulatory issues are raised, only the process of qualifying in advance the creditworthiness of the broker-dealer. The FRB would have full discretion to evaluate the worth of any collateral tendered at the time of any liquidity application. The FRB might permit the exercise of such special rights in the IBFC of a BHC itself, should the affiliated securities group request it. In such case, the FRB might determine the qualification for access rights itself.

11. Broker-dealer units owned by securities firms not affiliated with banking organizations would have the same payment system and Federal reserve window access rights as a banking organization's securities group. The relationship of the broker-dealer with the FRB would be a "credit" relationship, not an "insurance" relationship.

12. Registered broker-dealers not affiliated with a BHC would be permitted to own and operate federally insured institutions dedicated to "consumer banking," without limit on their growth and their activities within the consumer sphere. However, such a consumer banking institution would not be permitted to fund or support any of the securities activities of affiliated broker-dealers, except that it could assist and cooperate with the consumer retail securities brokerage operations of a broker affiliate in dealing with its customers.

Other Restructuring Proposals

The SIA Plan specifically addresses safety and soundness and fair competition concerns while simultaneously offering banking organizations as much "synergy" as they desire in their wholesale activities. Other proposals, such as the Proxmire Financial Modernization Act introduced by Senator Dixon, the Depository Institutions Affiliation Act introduced by Senators Cranston, D'Amato and Garn, the Corrigan proposal introduced by Senators Wirth and Graham, and the Financial Modernization and Safe Bank Act introduced by Senator Dodd, constitute legitimate and helpful contributions to the debate about new powers. However, as analyzed below, SIA does not believe these other proposals achieve the same balance of safety and soundness, fair competition and "synergy" desired by banking organizations which the SIA Plan provides.

The Proxmire Financial Modernization Act:

The Proxmire bill, which was passed by the Senate in 1988 and reintroduced in the 101st Congress by Senator Dixon, would permit banking organizations to engage in securities activities through separate securities affiliates of bank holding companies. The bill would also insert certain legislative "firewalls" between the securities affiliate and its affiliated federally insured banks. Those firewall provisions only go part of the way towards separating the federally insured bank from the banking organization's securities activities. For example, there is no prohibition of a federally insured bank providing credit in the same transaction in which its securities affiliate provides underwriting or other securities services. Such transactions raise numerous concerns about safety and soundness, conflict of interest and fair competition. An incomplete or permeable set of firewalls is likely to collapse under pressure.

More importantly, the Proxmire bill leaves the wrong type of activities on the wrong side of the firewalls. Securities-like activities, such as speculative foreign exchange, commodities trading and other risky activities that have no public policy rationale for being conducted in a federally insured institution, are permitted to remain in the bank. And, unlike the SIA proposal, the Proxmire bill offers no vehicle for conducting wholesale depository and credit functions on the same side of the firewalls as the banking organization's wholesale securities activities. This creates tensions and pressures that operate to the detriment of "synergy" as well as safety and soundness and therefore the temptation to break down firewalls is ever-present. To the extent firewalls are an impediment to providing both banking and securities services to a client, the objective of placing American banks on equal footing with European universal banks is not achieved. And to the extent the firewalls do not operate as an impediment, either because they are weak or because they are ignored, the securities activities of the banking organization wind up being merged with the activities of the affiliated federally insured bank, with damaging implications for safety and soundness on the one hand and fair competition vis-a-vis nonbank-affiliated broker-dealers on the other.

Finally, the Proxmire bill lacks features of the SIA Plan, such as direct access to the large dollar payments system for credit-qualified broker-dealers, emergency access to the Federal Reserve window and the opportunity for engaging in consumer banking, which are designed to promote fairer competition between banking and nonbanking organizations.

The Depository Institutions Affiliation Act:

This legislation, promoted by the Financial Services Council, is the most radical of the current proposals, in that it would eliminate current legal restrictions on the activities of banking organizations by in effect repealing the Bank Holding Company Act as well as Glass-Steagall. It would allow banking organizations to engage in all nonbanking activities, including securities, real estate, insurance, other financial services and commercial and industrial activities. While this legislation provides unlimited new powers for banking organizations, it is sketchy in its structure for dealing with safety and soundness concerns.

Beyond listing a limited set of activities that may not be conducted directly within federally insured institutions, the bill does not attempt to specify what would replace the existing legal structure. It leaves that function in the hands of a "National Financial

Services Committee" consisting of federal regulators and certain cabinet members, whose functions would include recommending firewall provisions to supplement the minimal firewalls specified in the legislation.

For the reasons discussed earlier in this Statement, safety and soundness concerns cannot be left only to regulators, as the thrift disaster has taught us. If Congress is to legislate new nonbanking powers for banking organizations, it must also legislate provisions that will insulate federally insured institutions and the federal taxpayer from economic risk in connection with such new activities, and ensure that government support is not used to unfair advantage in such new nonbanking activities.

The Corrigan Proposal:

The Corrigan proposal, as introduced by Senators Wirth and Graham in legislation filed in the 100th Congress, would allow bank holding companies to engage in all financial services, including securities, insurance and real estate, while preserving the separation between banking and commerce. However, it also relies on a super-regulator (this one named the Financial Services Oversight Commission) to develop the structure for the conduct of such new powers and to exercise responsibility for safety and soundness concerns in lieu of Congress.

The bill as drafted has no firewall or other provisions separating federally insured banks from their affiliates engaged in nonbanking activities, no requirement that securities or securities-related activities be transferred from federally insured banks to nonfederally insured affiliates, and no provisions for competitive equality between banking organizations and other financial services providers that do not own federally insured banks or benefit from government support.

The Financial Modernization and Safe Bank Act:

This bill, introduced by Senator Dodd, is a characterized as a variation on the "narrow bank" proposal espoused by Robert Litan of the Brookings Institution. The "narrow bank" portion of the bill is appended to the Proxmire bill, and would apply only to banking organizations that want more powers than those conferred in the Proxmire bill. Thus, with respect to banking organizations engaged in securities activities, this bill has the same shortcomings as the Proxmire bill discussed earlier.

For banking organizations that want nonbanking powers in addition to securities powers, the bill would make the Bank Holding Company Act's restrictions inapplicable provided each federally insured bank within the organization invested all its federally insured deposits in investment-grade securities. While this is intended to ensure that federally insured deposits are fully collateralized and therefore not at risk from the banking organization's other activities, the Dodd bill, unlike the pure "narrow bank" proposal, would place no limitations on the use of nonfederally insured deposits within a federally insured bank. Since the bill does not repudiate the "too big to fail" doctrine or otherwise ensure that government support would not be extended to depositors at federally insured banks whose deposits exceed the insured coverage limits, and since it does not require the transfer of securities, securities-related or other nonbanking activities out of its federally insured "safe banks," it may not achieve its stated objective of protecting the federal deposit insurance fund and the American taxpayer from the risks of new non-banking powers.

CONCLUSION

The time is at hand to reevaluate the structure for the conduct of the activities of banking organizations, in recognition of the expansion to date of their nonbanking activities and the perceived need for increased diversification in the future. The sine qua non for further expansion must be protection of the federal deposit insurance funds through the transfer of unnecessary risk from federally insured units of banking organizations to uninsured affiliates. At the same time, specific, self-executing rules must be established to ensure that federally insured institutions remain insulated from the activities of their affiliates and that such affiliates do not use government support to compete unfairly in nonbanking businesses. The development of such rules and the implementation of the new structure are the responsibility of Congress, and should not be left to regulators.

The new structure should include a mechanism, such as the investment banking financing company proposed in the SIA Plan for Taxpayer Protection and International Competitiveness, for the conduct by nonfederally insured units of banking organizations of wholesale depository and credit activities in conjunction with wholesale securities activities. Without such a mechanism, neither safety and soundness nor the objective of increased "synergy" for international competitiveness will be achieved. In addition, as banking organizations and securities firms become direct competitors in the securities business, securities firms should, when appropriate, have direct access to the payments system and emergency access to the Federal Reserve window at times of generalized liquidity crisis, and should be permitted to establish consumer banking affiliates.

As taxpayers and competitors in the securities business, SIA's members have a substantial interest in financial services restructuring issues. The issues are complex, but must be addressed comprehensively and in detail. SIA has developed a proposal which it believes addresses many of the concerns discussed in this Statement, and stands ready to work with this Committee and other participants in this important debate to further the objectives of ensuring our financial services industries remain competitive domestically and improving the international competitiveness of U.S. financial organizations, while privatizing financial services risks to the maximum extent feasible.

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Direct Dial Number

June 21, 1990

Mr. Edward M. Malan
Senate Committee on Banking, Housing
  and Urban Affairs
Room SD 534, Dirksen Senate Office Building
Washington, DC 20510

Dear Mr. Malan:

The enclosed supplemental testimony is submitted on behalf of Robert N. Downey, Chairman of the Securities Industry Association, to supplement Mr. Downey's testimony before the Committee on April 3, 1990 at the Committee's hearing on financial modernization. The supplemental testimony addresses questions raised at the hearing by Chairman Reigle as well as matters raised by Thomas Labrecque, who testified on the same date on behalf of various banking associations. For your convenience, a looseleaf version as well as a bound version of the supplemental testimony are enclosed.

We hope that the supplemental testimony can be included in the bound volume of the Committee's hearing along with the rest of the April 3 testimony. Please let me know if you have any questions.

Sincerely yours,

Leonard Weiser-Varon

Leonard Weiser-Varon

4118p

UNITED STATES SENATE
COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS

HEARING ON

MODERNIZING THE FINANCIAL SERVICES INDUSTRIES

SUPPLEMENT TO APRIL 3, 1990 STATEMENT OF
ROBERT N. DOWNEY, CHAIRMAN
SECURITIES INDUSTRY ASSOCIATION

TABLE OF CONTENTS

I. Regulatory Supervision of Financial Services

II. Response to Analysis of the SIA Proposal

UNITED STATES SENATE
COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS

HEARING ON

MODERNIZING THE FINANCIAL SERVICES INDUSTRIES

SUPPLEMENT TO APRIL 3, 1990 STATEMENT OF
ROBERT N. DOWNEY, CHAIRMAN
SECURITIES INDUSTRY ASSOCIATION

I. Regulatory Supervision of Financial Services

Chairman Riegle, in considering the safety and soundness issues relating to expansion of permissible activities for commercial banking organizations, has asked whether consolidated regulation of such organizations will be necessary as federally insured institutions are linked to providers of securities and other financial or non-financial services. The Chairman is understandably concerned that, at least during a transition period, the entire banking organization be monitored to ensure that the risks of new nonbanking activities conducted within the banking organization do not flow to the federally insured banks within the organization.

SIA agrees that the insulation of the federal taxpayer from risks posed by nonbanking activities of commercial banking organizations must be the paramount concern of any proposal to permit common ownership of providers of commercial banking and nonbanking services. However, although consolidated regulation of a bank holding company may be warranted, reliance on such bank-like regulation as the sole or primary source of protection for federally insured subsidiaries of bank holding companies risks a repetition of the thrift industry disaster. Excessive reliance on regulation also manifests itself in proposals to add a layer of consolidated regulation to providers of financial services that are not federally insured and are not part of a bank holding company. In SIA's view, extending the regulatory model for bank holding companies to organizations that are not bank holding companies and are not engaged in federally insured commercial banking would be unnecessary as well as counterproductive.

Congress and the American taxpayer cannot afford to repeat the experiment of permitting diversification of activities of federally insured institutions in reliance on the ability of regulators to ensure the continued safety and soundness of such institutions. When the thrift industry persuaded Congress that thrift organizations should be allowed -- either directly by Congress or by state legislatures -- to be given expanded powers in order to blaze new entrepreneurial trails with the help and assistance of their federally insured thrifts, statutory restraints were lifted and regulators became the only backstop for protecting federally insured deposits. But objective and prudent lending, an obvious first line of protection for financial institutions backed by the full faith and credit of the federal government, was a casualty in the entrepreneurial rush, and the regulators could not stem the tide of red ink that followed.

Now the commercial banking industry is making arguments similar to those of the thrift industry. Bank regulators, increasingly pressured to permit diversification by the banks they were established to regulate, have acceded progressively to their requests to open up loopholes in existing law, the Glass-Steagall Act and the Bank Holding Company Act primarily, to permit their expanded ownership and operation of nonbanking units. Advocates for integration of banking and nonbanking activities claim that such diversification is essential for survival and success, and that, though such diversification into securities activities may further threaten the already stretched federal deposit insurance funds, everything will be safe because an all-knowing, all-competent omniregulator can preserve the safety and soundness of commercial banking organizations in which federally insured deposits and nonbanking entrepeneurship are permitted to coexist.

Experience demonstrates that there is an almost irresistible temptation to misuse federally insured institutions when application of their deposits for entrepeneurial purposes is permitted. As FDIC Chairman William Seidman recently noted in the context of the thrift disaster, "[w]e gave the S&Ls a credit card on the United States government and said, 'Go ahead, spend it any way you like.'" This unhealthy situation is peculiar to federally insured institutions. Other providers of financial services must rely on their own capital and credit for survival; unlike a Bank of New England, they cannot rely on billions of dollars of federal credit to keep them going, and if they fail, they do not risk taking billions of federal dollars with them.

The existing contrast is between thrift and commercial banking organizations, which have created liabilities of hundreds of billions of dollars for the federal taxpayer notwithstanding a multitude of regulatory layers, and other providers of financial services, which have not cost the federal taxpayer a penny. Yet curiously enough, there is an assumption present in much of the present focus on regulation that a superregulator -- who presumably could be a beefed-up existing regulator -- not only is the answer to safety and soundness concerns for banking organizations seeking to break free of their current restrictions, but is also needed for other financial institutions that do not seek to combine federal deposit insurance with nonbanking commercial business activities.

The questionable assumption that superregulators can oversee commercial banking organizations effectively as they combine federally insured banking with securities and other nonbanking activities underlies most of those current restructuring proposals, which implicitly or explicitly propose prudential supervision by regulators as the primary or exclusive source of protection of the safety and soundness of federally insured affiliates of newly-created financial services holding companies. The reason for this is simple: the stated objective of financial services restructuring is to permit commercial banking organizations to benefit from the perceived synergies of being able to market a full spectrum of banking, securities and other financial or nonfinancial services and products. Structural barriers that isolate the commercial banking organization's federally insured units from securities or other affiliates or that limit interaction between the federally insured units and such other affiliates are seen as inherently inconsistent with the desired synergies. Therefore, enter the superregulator to permit the synergy desired while keeping things under control and simultaneously protecting the American taxpayer who is underwriting such dangerous synergies.

Proposals such as the Corrigan plan would dismantle existing statutory safeguards and permit federally insured banks to engage directly or through affiliates in a vast new array of financial activities without any significant statutory firewalls or other restraints to preclude such new risks from burdening the federal deposit insurance system; safety and soundness measures would be left primarily to the discretion of a superregulatory body. The inherent flaw in such a proposal is that it leaves the federally insured bank vulnerable to the nonbanking activities of its affiliates. The temptation is constantly present to tap the resources of the federally insured bank to promote the business of related affiliates. As Walter Wriston, Paul Volcker, Alan Greenspan and numerous others have observed, any business organization has a natural tendency to disregard corporate distinctions and use all available resources within a holding company in whatever manner is advantageous or necessary to maximize the health of the entire business organization. The temptation to use the federally insured bank's resources is particularly strong when such resources cannot be obtained from a dispassionate and unrelated supplier of credit.

The Financial Services Council proposal, which permits a merger of banking and commerce, likewise contains minimal statutory insulators to protect the federal taxpayer; it also relies principally on superregulators and on a few porous statutory restraints such as Sections 23A and 23B of the Federal Reserve Act. The temptation and opportunity to take advantage of the resources of the federally insured bank are left in place.

Enactment of such proposals would necessitate regulatory supervision of all affiliates of federally insured institutions because statutory constraints would not preclude the intra-organizational flow of risk. But placing all safety and soundness eggs in the regulatory basket is imprudent for a number of reasons. First, the presumption would be against any substantial prudential regulation, since every step taken to insulate the organization's federally insured units from the risks of their affiliates' activities would be a step away from the sought-after interaction of banking and nonbanking services. Second, as technological developments accelerate the pace, quantity and complexity of transactions, regulators already are increasingly handicapped in monitoring an organizations's activities in an accurate and current manner. Where will the resources and expertise be found to regulate effectively entire organizations engaged not only in depository and lending functions, but also in securities, insurance, real estate and even manufacturing activities? The built-in disincentives and practical obstacles to the type of comprehensive regulation of commonly-owned federally insured banking and securities firms underlying most restructuring proposals argue against reliance on such regulation as a substitute for structural safeguards. Comprehensive regulation is likely to be a costly, disruptive, ineffectual and ultimately counterproductive experiment.

The Glass-Steagall Act had the virtue of simplicity. The denial of common ownership of banking and securities operations was clear-cut and violations were readily apparent and could be policed. Simply put, since a bank could not be affiliated with any underwriter, it did not take much regulatory capacity to oversee the situation.

When common ownership of federally insured banks and securities operations is permitted for commercial banking organizations, the regulatory task becomes much more difficult. Specific, self-executing statutory safeguards are needed to ensure that any financial services restructuring does not unacceptably jeopardize the soundness of federally insured institutions. At the same time, such safeguards must not impede the joint conduct of commercial banking and other financial services if it can be done without involving federally insured banks.

SIA's proposal recognizes the conflicting desires which are present. There is the need to guard against unnecessary and unacceptable exposure of federally insured commercial banks to the risks to be undertaken by affiliates engaged in securities or other entrepeneurial ventures. At the same time, commercial banking organizations want to combine their credit capability with their securities activities.

SIA's plan reconciles this dilemma. It recognizes that, to counteract the continuing temptation to use the federally insured bank or thrift to support the securities activities of a commercial banking organization, an alternative source of credit is needed. SIA's proposal, involving the creation of uninsured or privately insured investment banking financing companies that can interact fully with securities and other affiliates, provides a mechanism for the desired synergy between credit operations and securities or other nonbanking operations that is compatible with maximizing the insulation of federally insured banks from the risks inherent in their affiliates' activities.

The only sure way of limiting the risk to federally insured commercial banks is to seal them off from their affiliates. SIA's proposal does this through strong legislative "no contact" rules that preclude the flow of money from federally insured banks to their "wholesale" securities affiliates or to the customers of such securities affiliates. Profits of federally insured banks could be dividended up to the holding company, but there would be no credit or other exposure by the federally insured banks to the activities of the securities affiliate. The sealing off of the federally insured bank would not prevent the joint conduct of banking and wholesale securities activities within the holding company, since the investment banking financing company could provide any depository or lending services that are desirable in conjunction with such securities activities.

The SIA proposal prevents the joint conduct of federally insured banking and wholesale securities activities, but permits the joint conduct of uninsured banking and wholesale securities activities. There is no policy reason why commercial banking organizations should be encouraged or permitted to use their federally insured banks in wholesale securities activities if a vehicle for securing and dispensing uninsured or privately insured funds is available. During the past half century the private sector has provided securities and securities-related services and built the world's strongest and deepest capital markets in this nation without any need for government support or subsidy; that is one aspect of financial services that should not be "restructured."

A structure which limits the flow of funds from a commercial banking organization's federally insured bank or thrift to its affiliates and the flowback of risk from such affiliates' activities to the federally insured bank or thrift is a structure capable of operating without unrealistic reliance on prudential regulation of the entire holding company. Banking regulators can monitor the capital adequacy and activities of the federally insured institutions; affiliates can be functionally regulated by other regulators on the basis of the activities performed by those affiliates.

Sensible financial restructuring can occur only within the framework of a structure that makes the success or failure of newly authorized activities irrelevant to the health of federally insured institutions. This requires, of course, repudiation of the "too big to fail" doctrine, or, if regulators do not think complete repudiation is feasible, at least ensuring that the doctrine is applied, if at all, to federally insured institutions exclusively, not to their affiliates. A corollary requirement is that activities which as a policy matter do not require or justify federal support should be transferred out of the federally insured units and into the uninsured units of the bank holding company. SIA's proposal meets these requirements: it would legislatively preclude and prohibit use of federal deposit insurance funds to bail out bank affiliates, and it would require commercial banking organizations that seek new securities and securities-related powers to form separate holding company affiliates in which all such activities would be conducted. Parties entering into transactions with such affiliates would be on notice that such affiliates are not federally supported, just as they were with a securities firm like Drexel, and would have no expectation of a government bailout if such an affiliate failed.

SIA's proposal also differs from the Corrigan, Financial Services Council and similar proposals for financial services holding companies in that it provides for a built-in transition period in which expansion of the powers takes place within the context of the Bank Holding Company Act, and does not require creation of a new regulatory structure. The Federal Reserve Board would remain in place to monitor the bank holding company as it creates and operates investment banking financing companies and securities subsidiaries and transfers securities and securities-related activities from the holding company's federally insured banks and thrifts to the separate securities subsidiaries. However, SIA's proposal would not rely solely on the Federal Reserve Board's monitoring to ensure the safety and soundness of the holding company's federally insured institutions; the "no-contact" rules insulating the federally insured units from the new nonbanking activities would be the primary safeguard. After an adequate transition period, Congress might reexamine the unique nature of bank holding companies presents a continuing need for the Federal Reserve Board to remain as the overall regulator for bank holding companies notwithstanding the self-executing nature of the statutory safeguards.

SIA's proposal also takes a more incremental approach than many of the other proposals to the affiliation of commercial banking organizations with entities engaged in nonbanking activities. The SIA proposal would start with securities and securities-related activities, and does not involve the simultaneous entry of banking organizations into insurance, real estate or commerce. However, the principles of SIA's proposal could be adapted to other activities after a transition period in which the effectiveness of the proposal is tested in the context of securities and securities-related activities. If a structure that immunizes federally insured units from the activities of their affiliates can be developed, it will not matter what activities are conducted in those affiliates.

By preserving the distinction between bank holding companies and other organizations that provide financial services, SIA's proposal also eliminates the need for an omniregulator for private sector organizations that have been operating efficiently without such regulation. Operations of the securities industry have not implicated the resources of the U.S. government or the federal taxpayer. While SIA's proposal would permit bank holding companies to engage in the full spectrum of securities and securities-related activities, other organizations that do not engage in full-scale commercial banking would gain only limited privileges in three areas that would not increase the burden on the federal deposit insurance system:

1) SIA's proposal would permit credit-qualified broker-dealers (as well as securities subsidiaries of bank holding companies) to borrow from the Federal Reserve on a fully collateralized basis in times of generalized liquidity crisis such as October 19 and 20, 1987; statutory authority for such borrowings already exists, and the proposal would simply put in place procedures for such emergency borrowings. This type of access is not the Federal Reserve "discount" window access available to federally insured banks.

2) SIA's proposal would provide for access by qualified broker-dealers to the large dollar payments system, within the context of a privatized system designed to minimize any potential need for Federal Reserve Board credit support or intervention.

3) Broker-dealer organizations would be permitted to own limited purpose consumer banks that are federally insured. These consumer banks would be identical to the presently existing grandfathered nonbank banks owned by certain securities firms and industrial firms. Because such banks would not interact with or otherwise support their affiliates engaged in wholesale securities activities, they would be insulated from the activities of their nonbanking affiliates and would be functionally regulated by their primary bank regulator (the FDIC) without any need for consolidated regulation of the entire organization.

II. Response to Analysis of the SIA Proposal

Thomas Labrecque's testimony on behalf of the American Bankers Association, the Association of Bank Holding Companies, the Association of Reserve City Bankers, the Bank Capital Markets Association and the Consumer Bankers Association contains a critique of the SIA Plan for Taxpayer Protection and International Competitiveness. Mr. Labrecque's critique is in essence an advocacy piece for permitting banking organizations to engage in a variety of new nonbanking businesses, including the securities business, without any significant restrictions on their abilities to involve their federally insured banks in such new businesses.

The critique takes issue with SIA's proposal because it does not permit a federally insured banking organization to become a universal bank with full access to federally insured deposits for all its activities. In light of the lessons of thrift industry "deregulation", however, this is the central virtue, not a defect, of the SIA proposal. What the SIA proposal does is permit banking organizations to obtain domestic and international securities powers within a framework that eliminates any need, and any possibility, of involving their affiliated federally insured banks in those risks.

Deposit Insurance Is The Issue

The bankers' critique contains a variety of arguments to the effect that there is nothing wrong with allowing banking organizations to use federal deposit insurance in their securities and other nonbanking businesses. The banker's primary argument is that, since the securities industry is seeking access to the Federal Reserve in times of generalized liquidity crises and to the large dollar payments system maintained by the Federal Reserve, banking organizations should be able to call on the entire federal safety net, including federal deposit insurance, to run their securities operations. To accept such an argument is to ignore the lessons of the thrift industry collapse and the many bailouts of the banks themselves by the FDIC in recent years.

The SIA proposal provides that, in times of generalized liquidity crises only (e.g., October, 1987), pre-qualified broker-dealers (as well as IBFCs owned by bank holding companies) would be able to borrow directly from the Federal Reserve on a fully collateralized basis. This request arises only because commercial banking organizations will become full-line direct competitors of securities firms, and securities firms should not be wholly dependent on their competitors to make objective judgments at such times. Securities firms, instead of being required to borrow from banking organizations which would be their direct competitors, could, once pre-qualified by the SEC, go directly to the Federal Reserve in such rare emergency situations.

Under existing law, the access to the Federal Reserve's credit already is available to all banking and non-banking firms in the Federal Reserve Board's discretion for collateralized loans of up to 90 days. SIA's proposal would do no more than regularize the procedures for such access in the case of broker-dealers facing a generalized liquidity crisis. This is far different from the banks' access to the Federal Reserve discount window. SIA does not seek access for its members to the Federal Reserve at any other time.

In October, 1987, the Federal Reserve supposedly provided all of the liquidity needed to commercial banks. However, even then, when banking organizations were only partial competitors, E.F. Hutton, according to an SEC study, did not get the credit it should have because the bank it was dealing with changed the rules of payment and settlement on a foreign exchange transaction; Hutton was not able to survive as an independent securities firm. In addition, major firms with very strong balance sheets were subjected to wild rumors worldwide and had more than a few anxious moments about funding from these partial competitors. When banking organizations are full-time competitors in the securities business, the situation will likely be even worse, should such a liquidity crisis recur. Implementation of the regularized procedures contained in SIA's proposal would avoid the necessity for a broker-dealer to be wholly dependent upon a competitor for its fully-collateralized funds at times of generalized liquidity crisis.

Under SIA's proposal, commercial banking organizations through their IBFCs and broker-dealers of securities firms would have identical direct access in times of generalized liquidity crises to Federal Reserve funding on a fully secured basis. The bankers'critique asserts that "despite the SIA rhetoric about how risky the securities business is, it has effectively abandoned this claim by asking that securities firms be given emergency access to the Federal Reserve ... and the nation's [large dollar] payments system." It is intellectually dishonest to compare, as the bankers' critique does, the "risk" associated with the ability of pre-qualified firms to borrow on a fully-secured basis in generalized emergency situations to the genuine risks to the American taxpayer of federal deposit insurance, which in effect supports all of the debts of every major federally insured bank and thrift in America.

Equally misconceived is the attempt to analogize SIA's proposal for direct access by broker-dealers to the large dollar payments system to the bankers' apparent desire to expand the nonbanking activities of federally insured organizations without structural measures to protect insured deposits and the federal taxpayer. SIA supports a privatized payments system that would not require government support. The privately operated CHIPS system recently introduced measures to create settlement finality and eliminate credit risk from that payments system. Similar changes are being discussed for the Fedwire payments system. SIA believes that creditworthy broker-dealers should have access to such a privatized payments system, just as creditworthy banks would. SIA seeks no government support or specialized treatment in this connection.

Federal Deposit Insurance is a Competitive Advantage

The bankers' critique also characterizes as erroneous the proposition "that the ability to offer insured deposits offers a significant competitive advantage to banks." Common sense and experience indicate that federally insured banks borrow for less cost than they would if they did not have such federal backing. As Federal Reserve Board Chairman Alan Greenspan observed in a May 10, 1990 speech, "[t]he safety net lowers the risk premium on bank liabilities, permitting banks to operate with lower capital or with higher-risk asset portfolios. Both the lower deposit rates and the smaller capital base reduce banks' costs, permitting them to profit more from the same portfolio." One need only compare the rates paid by bank insured accounts and the yields of high quality money market funds managed by broker-dealers; how explain the 100 to 200 basis point difference except by federal deposit insurance? The ability of banks to use such subsidized funds in their securities activities and to obtain securities business by leveraging their credit clout is an enormous competitive advantage. If banking organizations do not believe that federal deposit insurance is a competitive advantage, it is hard to understand why they resist with such vigor proposals to require the separation of their securities activities from their federally insured banks.

If Banks Are Allowed to Compete Fully in the Securities Business, Securities Firms Should be Permitted to Operate Retail Banks

Contrary to the mistaken assertion in the bankers' critique, SIA is not building into its proposal any special advantages for securities firms vis-a-vis banking organizations. The proposed authority for securities firms to own federally insured consumer-oriented banks merely attempts to create competitive equality; if banking organizations are to compete fully in the securities business, securities firms should not be precluded from participating in the banking business at the retail level. The additional risk to the federal deposit insurance system from such consumer-oriented banks is minimal and would be far less than that for regular full-line commercial banks, which are permitted to incur risk from loans for leveraged buyouts, third-world debt and the like. The competitive benefits to consumers of an additional group of banks devoted exclusively to consumer credit are obvious.

Under the SIA proposal, such consumer-oriented banks of securities firms would provide banking services primarily to individuals, not wholesale banking, and would be permitted to interact with the retail securities brokerage services offered to customers by securities firms. There could be no direct or indirect support for the wholesale securities operations of the securities firm by the consumer-oriented bank.

Transferring Wholesale Activities to the IBFC Makes Functional Sense

The bankers' critique asserts that, because of the strong firewalls contemplated by the SIA proposal, a federally insured bank, in order to benefit from new securities powers, "would have to transfer all of its wholesale credit activities to an IBFC while using insured deposits to fund only its retail activities." The SIA proposal, it is hoped, would encourage such transfers, but does not require such transfers unless a banking organization desires to provide new wholesale securities activities to the same customers for which it provides wholesale credit. SIA believes, however, that it would be in the national interest if ultimately the federal deposit insurance system were to cover only retail activities, and all risky "wholesale" banking, securities and other activities were fully "privatized" by being conducted through a banking organization's non-insured IBFC and its securities subsidiaries.

Contrary to the bankers' claims, most banking organizations with an active interest in securities and securities-related activities should not experience operational inefficiency or additional personnel costs by integrating wholesale activities in the IBFC complex. Most banking organizations already use different personnel for their wholesale transactions and customers than they do for their retail business. And, of course, banking organizations that do not elect to enter securities and securities-related activities specified by the new legislation can continue operations as at present.

If anything, SIA's proposal promotes efficiency by establishing a vehicle for the conduct of uninsured or privately insured banking together with wholesale securities and securities-related activities. All authorized wholesale business conducted by a banking organization could be centralized in the IBFC complex, permitting the synergies (which banking organizations claim exist) to be developed across the board on the wholesale level. For this reason, under the SIA proposal, securities-related activities such as speculative foreign exchange trading, financial advisory services, merger and acquisitions advice and private placement activities would be transferred to the IBFC's subsidiary units, where they would be outside of the cocoon around affiliated federally insured banks, thereby permitting all needs of wholesale customers to be serviced simultaneously without any firewall-type impediments.

As noted, under the SIA proposal, only banking organizations that elect to engage in new securities powers through the IBFC structure would be required to transfer such securities related activities to the IBFC complex.

Federally Insured Universal Banks Are Not the Answer for American Competitiveness

The bankers' critique asserts that a framework for universal banking must be developed if the United States financial services industries are to remain competitive internationally. The merits of universal banking are not universally recognized. Where universal banking has existed, as in West Germany, creative, less expensive financing alternatives were not developed. The most dynamic and successful capital markets are in Japan and the United States, both of which operate under a legal structure that separates commercial and investment banking.

Japanese Banks Operate under the Same Restrictions as U.S. Banks

Contrary to Mr. Labrecque's suggestion that Japanese banks have greater powers under Article 65 of the Japanese Securities and Exchange Law than American banks do under Glass-Steagall, the two sets of restrictions are virtually identical. Mr. Labrecque erroneously suggested in his oral testimony that the passive investment in Goldman, Sachs & Co. by a subsidiary of Sumitomo Bank indicates that Article 65 restrictions on affiliations between Japanese banks and securities firm are looser than the restrictions applicable to American banks; the fact is that, under the Glass-Steagall Act, any American bank holding company would be free to make a passive investment such as Sumitomo's investment in nonvoting shares of Goldman, Sachs & Co., which represents a 10-year investment in 12.5% of the profits of Goldman, Sachs & Co.. Similarly, the 5% investments by Sumitomo Bank Ltd. in insurance and securities firms described by Mr. Labrecque are equally available to United States bank holding companies under the Bank Holding Company Act of 1956. While Japanese banking organizations, unlike their American counterparts, like to maximize the use of these passive investment provisions, such cross-shareholdings do not alter the fact that Japanese banks have reached their current status within a structure that absolutely precludes universal banking, and operate under a strict law that mirrors the Glass-Steagall Act, but without regulator-created loopholes.

SIA believes it would be counter-productive, unnecessary and dangerous to permit universal banking that involves the use of affiliated federally insured banks ultimately backed by the American taxpayer. The United States cannot afford international competitiveness purchased with the potential price tag of massive future bailouts of a universal banking industry. SIA invites the banking associations represented by Mr. LaBrecque and other interested parties to join it in supporting a structure that will allow American institutions to compete internationally, and compete effectively, without American taxpayer backing.

The "Synergies" Banks Seek May be Elusive

The bankers' critique asserts that SIA's proposal constitutes an acknowledgement of the economic benefits of combining banking and securities activities under one roof. Our proposal does no such thing. SIA continues to believe that the synergies so frequently mentioned by the banking industry may prove hard to find. Banking and securities are both difficult businesses requiring different sets of skills.

Therefore, the synergies banks believe exist may not in fact exist. A decade or so ago this nation went through a period of constructing industrial conglomerates. The past few years have seen the dismantling of many such conglomerates; somehow, the hoped-for synergies did not materialize. Running a demanding business requires much skill; running several diverse demanding businesses is even more of a challenge. Ironically, banks may now be seeking to repeat the mistakes of industrial conglomeration by engaging in what Peter Lynch, the noted fund manager, calls "di-worse-ification." In any event, Uncle Sam through federal deposit insurance should not be underwriting such diversification. Diversification of banking organizations should only be done on a totally privatized basis.

SIA's proposal is not based on an assumption that combining banking and securities businesses is necessary or desirable. Instead, it offers a structure for organizations that, correctly or incorrectly, perceive it to be in their interests to combine such businesses to do so without prejudice to the American taxpayer and without destroying the chances for independent securities firms to survive.

Conclusion: Let Banks and Securities Firms Compete Without Implicating the American Taxpayer

Because SIA's focus in its proposal has been on a structure that works to protect the American taxpayer and to provide for at least some level of fair competition, the proposal has not attempted to specify the full spectrum of activities that could be carried on by a banking organization within the IBFC complex. Those issues are for the Congress to decide, once there is a structure that works.

The premise of SIA's proposal is that, with the suggested structure in place, Congress could safely grant IBFC securities subsidiaries of banking organizations full securities powers. There is no reason that other nonbanking activities that are currently precluded for banking organizations by the Bank Holding Company Act of 1956 could not be accommodated within the proposed structure in time. Contrary to the suggestion in the bankers' critique, SIA is not seeking a structure in which securities firms have a cross-marketing advantage over banking organizations.

Federal deposit insurance was established in the 1930s to provide a secure haven for the individual depositor's money. The benefits that banks derived through their access to guaranteed funds and related banking advantages were incidental to the purpose of providing depositor security. It was never intended that deposit insurance become a crutch for an ever-expanding complement of nonbanking activities.

A securities industry, an insurance industry and other financial and non-financial industries have developed that do not depend on federal deposit insurance or add risk to such deposit insurance through their own activities. Federally insured banks support the activities of such unrelated organizations by impartial credit decisions unaffected by their own entrepreneurial interests. SIA welcomes banking organizations that deem it necessary for their international competitiveness or other reasons to enter the securities business, or other businesses, and to combine their lending and credit activities with such nonbanking activities; but such entry should be on the same terms as everybody else: without involving affiliated federally insured banks in any manner.

The **Chairman**. Thank you, Mr. Downey. We have been joined by Senator Heinz.

Senator Heinz, did you have a comment that you want to make at this point?

Senator **Heinz**. Mr. Chairman, I do have a statement that I would ask unanimous consent to put in the record. But with apologies to our two witnesses, and I have not been briefed by Senator Garn on what he or Senator Riegle said, but this does remind me of Yogi Berra's famous saying of deja vue all over again to have you two back for about the fourth or fifth consecutive Congress. Sometimes the faces change, but the tune, the various tunes, while the harmonies may also change, still linger on.

Welcome back to the longest running debate in the history of this committee, and perhaps any. Thank you, Mr. Chairman.

The **Chairman**. We will make it a part of the record. I also will insert in the record a statement of Senator Graham.

OPENING STATEMENT OF SENATOR HEINZ

Senator **Heinz**. Mr. Chairman, I join you in welcoming today's distinguished representatives of the banking and securities industry as we examine the structure of our financial service industry. As the result of policy changes announced by the securities industry association last December, this is the first time I feel safe seating these two witnesses at the same table. This is the closest these two industries have been to each other since 1934.

While I would like Congress to take the credit for bringing the securities and banking industries together, market forces and the institutionalization of our capital markets are responsible for this reunion. Both industries recognize that our Nation's leadership in financial services is eroding by stiff competition abroad. At home, these industries complete head to head with products and services that are hard to tell apart, while the systems under which they operate are worlds apart.

Senator Dodd and I just returned from the European Community where they are creating a framework for an integrated financial service industry that will span 12 countries and invite competition from around the globe. The European Community is grappling with many of the same issues confronting this committee relating to the creation of level playing fields, the protection of depositors and investors, and the maintenance of a secure financial system.

Mr. Chairman, I am hear to report that the European Community does not have any simple solutions or easy answers either. But they are making tough choices and significant progress as they march toward the end of 1992. I am pleased that this committee is prepared to do the same.

OPENING STATEMENT OF SENATOR GRAHAM

Senator Graham. Mr. Chairman, I look forward to the start of this series of hearings on financial modernization and deposit insurance reform issues which the committee will be holding in April and May.

In 1987, Senator Wirth and I introduced S. 1891, the Financial Services Oversight Act, based on New York Federal Reserve President Gerald Corrigan's report, Financial Market Structure: A Longer View. We wanted the bill to be part of the broader discussions on financial modernization issues facing the 100th Congress, which it was. However, 1988 was not the right year for a major comprehensive piece of financial modernization legislation.

The approaching years look better for a more comprehensive review. The traditional narrow lines of banking and commerce are continuing to blur as the industries respond to change. Loopholes and court challenges and the variable nature of international and domestic economics have and are altering the landscape. While Congress has been involved in other issues the world has not waited. The Congress needs to reassert its traditional primary role in establishing the structure of America's financial systems.

Senator Wirth and I will be reintroducing the Financial Services Oversight Act later this week as the Financial Services Commission Act. This legislation still needs to be on the table to encourage the kind of probing and exhaustive consideration of the future of our financial industries which an architectural approach demands.

The American consumer and the financial industry need a realistic and contemporary, secure and prudently regulated system to provide America's financial services—now and well into the 21st century. Hopefully, these hearings start the steps down the road for financial modernization.

The CHAIRMAN. Senator Heinz, we made the observation that in years past the space between the witnesses has been wider. In other words, for whatever the reasons, they chose to sit further apart and that there seems to be a coming together at the witness table.

Senator HEINZ. Is that the Fed's safety net that is drawing them closer? [Laughter.]

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Heinz.

Mr. Labrecque, we would be pleased to hear from you next.

STATEMENT OF THOMAS G. LABRECQUE, PRESIDENT OF THE CHASE MANHATTAN CORP., NEW YORK, NY, REPRESENTING THE AMERICAN BANKERS ASSOCIATION, THE ASSOCIATION OF BANK HOLDING COMPANIES, THE ASSOCIATION OF RESERVE CITY BANKERS, THE BANK CAPITAL MARKETS ASSOCIATION, THE CONSUMER BANKERS ASSOCIATION, THE COALITION FOR REGIONAL BANKS

Mr. LABRECQUE. Mr. Chairman, members of the committee, I am Thomas G. Labrecque, president of the Chase Manhattan Corp. I appreciate this opportunity to be here this morning to represent six banking groups.

We have a single message: Our Nation's financial system, indeed the financial influence of the United States in the world stands in a precarious position. It is not overly dramatic to suggest that it is high noon for the U.S. banking industry, and it is urgent that Congress act to pass legislation to restore America's competitive balance in financial services. The legal and regulatory structure that constrains the role of all providers of financial services must be reformed.

A decade ago our banking and financial services industry was preeminent in the world. Sadly, that is no longer the case. We have known for many years that fundamental reform is required, but we have done little.

The price of continued inaction, as it was with steel and autos, television sets, and semiconductors, will be continued deterioration.

Mr. Chairman, I am not here asking for some specific new powers for banks. I am here to show the support of six banking organizations for financial reform to provide a two-way street allowing all financial services firms to offer the full array of financial products to their customers.

Equally important is the appearance of the SIA. The SIA's proposal is a signal that it, too, is prepared to support fundamental restructuring of the financial services industry, including repeal of the Glass-Steagall Act. Under the pressures of economic reality, a legislative log jam three generations old is finally breaking up.

Our sense of urgency arises from the facts. The data that illustrate the downward spiral of U.S. banks in the 1980's are set forth in detail in the prepared statement. Let me highlight the key points:

Constrained by the Glass-Steagall Act and the Bank Holding Company Act, we have experienced accelerating disintermediation on both sides of the balance sheet during the past decade. Ford, Prudential, General Electric, Sears, and American Express are legally permitted to offer essentially a complete array of financial services. United States banks cannot. As a consequence, U.S. banks have lost market share in the core business of banking and are less efficient, more risky, and less capable of serving the needs of our customers and the Nation's economy.

These problems are as real for community banks across the country as they are for money center banks in New York or California. Investment companies, securities firms, insurance companies, and foreign banks attract customers nationwide by providing services that U.S. banks cannot match.

Other Nations are taking steps to enhance the ability of their institutions to serve their—and our—customers. In connection with Europe 1992, the European Universal Banking Model of integrated financial services will be the norm. In Japan, the revision of article 65 will leave the United States as the only major country continuing to impose extensive product and service barriers among financial institutions.

What we must realize is that changing this situation is within our power. It is a question of adopting a global perspective and summoning the political will to act.

Here is what we think should be done:

First, we must make modernization of our financial services industry a national priority. At their inception, the Bank Holding Company Act and the Glass-Steagall Act divided the financial services business in a way that was arbitrary but workable. By 1980, market innovations had rendered the situation incoherent and unstable. Nonetheless, over the decade reform never emerged as a national priority. It was viewed as the same old turf war between the banks, the SIA, the insurance industry, and others. This is no longer the case.

Fortunately, much of the analytical work for modernization has been done. There are several models consistent with the principles enumerated in our prepared statement. But the time for study is over. We must get to work with Congress, the administration, and the agencies to reach a legislative conclusion quickly.

I would raise one note of caution. Beware of those who would impose broad restrictions such as firewalls, beyond the current legal restrictions. New legislatively mandated restrictions should be enacted only in the face of clear evidence of abuse not contemplated by the existing framework of law and regulation. All too often such restrictions are merely a last resort of those who wish to maintain current market advantage.

A second piece of the legal framework is the current system of deposit insurance, which is also in critical need of revision. The costly demise of the FSLIC demonstrates that the present system can encourage the weakest institutions to take the greatest risks.

My own view on this issue is clear: We must eliminate the notion of the so-called "too big to fail" policy under which large banks are given de facto 100 percent protection of all deposits. Such a policy is inconsistent with the original intent of deposit insurance and is unfair to smaller banks. Furthermore, big bankers neither want it nor need it.

We should allow insurance only of deposits up to $100,000. The original law was designed to protect the core deposits of the average American, not multiple $100,000 deposits of huge institutions.

This approach would return the system to its original purpose, to protect the average American. It would introduce an element of discipline to a system that has become unnecessarily costly and burdensome. It would reduce insurance costs to U.S. banks making them more competitive with foreign and nonbank competitors. Most importantly, it would reduce the contingent liability that U.S. taxpayers would be forced to pay if the system went awry.

Mr. Chairman, the six organizations I represent agree that the time has come for the United States to chart the future of its financial services industry. Failure to act has undermined the foundations of our industry. At the same time Japan and Europe have strengthened their banks vastly beyond what we might have believed possible a short decade ago.

Permit me to give you just a few numbers. In asset size, the top ten Japanese banks are more than three times larger than the top ten U.S. banks.

In deposits, the top ten Japanese banks are almost six times the size of the top ten U.S. banks.

Perhaps the most important measure is market capitalization. The aggregate capitalization of the top ten U.S. banks is just under $50 billion. By contrast, the Sanwa Bank of Tokyo is capitalized at over $50 billion and is itself larger in market capitalization than the top ten U.S. banks put together. Even worse, Mr. Chairman, there are five other Japanese banks whose capitalization is even larger than Sanwa. The implications of all this for our own banks are ominous.

Mr. Chairman, be assured that these arguments are not the special pleading of another executive advancing the cause of his own company.

The fact is, our Nation's economic strength is intertwined with our Nation's financial strength. In an imperfect world such as the one in which we live, there is no guarantee that a U.S. company competing head to head with a foreign company will be treated equitably by a foreign bank.

If we are to remain competitive in global markets and stable and healthy at home, we must strengthen our own banking system. We have no other choice.

Mr. Chairman, and members of the committee, leadership is urgently needed now to develop a national policy on financial services and a politically feasible action plan to achieve that policy.

Finally, we are calling on you to shoulder that burden, I pledge my commitment, that of my colleagues at Chase, and in the banking industry at large to work with you to achieve what must be regarded as an urgent national priority.

Thank you.

[The prepared statement of Thomas G. Labrecque follows:]

SUMMARY STATEMENT OF THOMAS G. LABRECQUE

ON BEHALF OF

THE AMERICAN BANKERS ASSOCIATION
THE ASSOCIATION OF BANK HOLDING COMPANIES
THE ASSOCIATION OF RESERVE CITY BANKERS
THE BANK CAPITAL MARKETS ASSOCIATION
THE CONSUMER BANKERS ASSOCIATION

APRIL 3, 1990

I am Thomas G. Labrecque, President of the Chase Manhattan Corporation. I am here today in a rather unique role as a representative of five major bank trade associations. I appreciate this opportunity to present our views on the urgent need to modernize the structure of the financial services industry.

We have a single message -- the legal and regulatory structure that constrains the roles of all financial service providers must be modernized. The fact that I am here today to speak for five associations clearly demonstrates both the gravity of the competitive problems facing the banking industry and the strong consensus within the industry on the basic approach to creating a more flexible and competitive financial structure.

Banks are not alone in calling for reform -- many members of the broader financial services industry also recognize that the existing regulatory structure is impeding the competitiveness of U.S. institutions. For example, John Gutfreund of Salomon Brothers recently pointed to our "fragmented" financial system and its "morass of outmoded regulations" as obstacles to building strong domestic financial institutions.

The competitiveness of all sectors of our economy is heavily influenced by public policy decisions. This simple fact is painfully clear to banks of all sizes as they try to cope with the realities of today's financial markets while they remain shackled by outdated laws and regulations.

Banks have already lost large segments of their traditional markets to other financial service providers in the United States. Constrained by the Glass-Steagall Act and the Bank Holding Company Act, banks have experienced accelerating disintermediation on both sides of the balance sheet during the past decade. Ford, Prudential, Merrill Lynch, American Express and others are legally permitted to offer an essentially complete array of financial services. U.S. banks are not. As a consequence, U.S. banks have lost market share in the core business of banking, leaving them less efficient, more risky and ultimately less capable of serving the needs of our customers and the nation's economy.

In the global arena, growing international competitive pressures have sparked a wave of regulatory reforms in other industrialized countries. In 1992, the universal banking charter will become the norm in Europe, allowing European banks to offer a full range of financial services without overly restrictive firewalls. And in Japan, which already has the 10 largest banks in the world, the Ministry of Finance is poised to liberalize Japanese banking laws to permit bank subsidiaries to engage in securities activities. This dynamic modernization gives foreign financial markets and institutions a head start in developing innovative services to meet the needs of the future. The greater their head start, the harder it will be for our institutions to catch up.

While I represent a large bank, let me assure you that these problems are just as real for community banks across the country as they are for money center banks in New York. Investment companies, securities firms, insurance companies and foreign banks attract customers nationwide by providing combinations of financial products that banks -- large and small -- cannot match. We have already seen the effect of global competition on our domestic manufacturing base. The same pressures are operating on financial services. Just as local car dealers have to compete with Toyota and Volkswagen, U.S. community banks will soon find themselves competing with Sumitomo and Deutsche Bank.

The consequences of losing our competitive edge in international financial markets go beyond the banking industry -- our loss of financial leadership will also reduce the competitiveness and market share of other U.S. industries, especially export-oriented industries. Equally important, the United States cannot remain a leading player in the emerging global economy and international political system if its banks are being swept aside in the competitive arena.

There is a growing consensus among participants in the financial services industry, Members of Congress, regulators, and the Administration about the need to modernize our financial structure. Let me outline some principles we believe should guide financial modernization.

First, while we should not blindly copy the systems put in place by foreign governments, we must recognize that the U.S. can not insulate itself from events in foreign markets. Our financial institutions must be given the flexibility to provide a wide variety of financial products that will enable them to compete freely and fairly in the U.S. and in markets around the world.

Second, there must be sufficient flexibility in the system to allow all financial institutions -- securities firms and insurance companies as well as banks -- to respond to changing market realities. A flexible financial system will ensure that consumers have the widest possible choice of products from a variety of financial service providers at competitive prices, and will prevent our financial institutions from being left behind as technology, demographics, and economic conditions change.

Third, regardless of the structural vehicle for offering expanded products and services -- universal banks, subsidiaries, affiliates, holding companies, etc. -- the regulatory structure should treat all financial service providers equally. In other words, regulation should apply to a specific function rather than to a particular type of institution.

Fourth, the regulatory system should provide adequate safeguards to protect the deposit insurance system -- and ultimately the taxpayer -- from systemic risk. Existing laws and regulations form a solid basis for protecting depository institutions from any losses incurred by an affiliate. It is critical, however, that our efforts to protect the system do not destroy the benefits gained from expanded product and service authorities. If the firewalls placed on our institutions are overly restrictive, we will not have accomplished much in our quest for increased competitiveness.

We believe that the modernization we have recommended can be accomplished without overhauling the entire regulatory and supervisory structure. With relatively minor modifications, and with the use of functional regulation, the current regulatory framework is capable of accommodating the changes needed to make our financial system competitive.

The issue of deposit insurance reform is of the utmost importance to bankers. Let me just outline for you some of the basic factors our five associations think deserve close attention during the reform process.

The central problem with our system of federal deposit insurance is rooted in the FDIC's current method for resolving bank failures. By its words and actions, the FDIC has created the widespread impression that it stands ready to provide 100 percent guarantees to uninsured depositors. There have been only infrequent exceptions to this policy of de facto 100 percent deposit insurance coverage, and the exceptions have all involved smaller banks. This policy creates the perception that some banks are "too big to fail"; results in unequal treatment of depositors at large versus small banks; and undermines market discipline by reducing the incentive for large depositors to analyze the financial strength of the institutions in which they place their funds.

Each of the five trade associations I represent here today agrees that 100 percent deposit insurance -- de facto or de jure -- is not acceptable.

The alternative is a federal deposit insurance system which encourages market discipline. As uninsured depositors make more careful assessments of their risk exposure, poorly managed banks will find it more difficult and expensive to raise funds, limiting their ability to grow. Over time, an increasing share of the banking business will be channelled to well-managed, sound institutions. The result will be a stronger banking industry, and less risk for the deposit insurance fund.

For market discipline to work, the current "too big to fail" policy must be renounced. No bank -- large or small -- should be too big to fail, and no large uninsured depositor should be granted full coverage if the FDIC suffers any losses in resolving the failure. In the past, the biggest problem in using a market discipline approach was the lack of a resolution framework capable of handling a large bank failure. Development of such a framework is a difficult problem -- but it can now be done.

STATEMENT OF THOMAS G. LABRECQUE

ON BEHALF OF

THE AMERICAN BANKERS ASSOCIATION
THE ASSOCIATION OF BANK HOLDING COMPANIES
THE ASSOCIATION OF RESERVE CITY BANKERS
THE BANK CAPITAL MARKETS ASSOCIATION
THE CONSUMER BANKERS ASSOCIATION

APRIL 3, 1990

I. Introduction

Mr. Chairman and Members of the Committee, I am Thomas G. Labrecque, President of the Chase Manhattan Corporation. I am here today in a rather unique role as a representative of five major bank trade associations: the American Bankers Association; the Association of Bank Holding Companies; the Association of Reserve City Bankers; the Bank Capital Markets Association; and the Consumer Bankers Association.

Mr. Chairman, I commend you and your Committee colleagues for holding these hearings, and I appreciate this opportunity to present our views on the urgent need to modernize the regulatory structure of the financial services industry. Let me add that it is no small feat to represent five trade associations -- the fact that I am here today clearly demonstrates both the gravity of the competitive problems facing the banking industry and the strong consensus within the industry on the basic approach to creating a more flexible and competitive financial structure.

Banks are not alone in calling for reform -- many members of the broader financial services industry also recognize that the existing regulatory structure is impeding the competitiveness of U.S. institutions. For example, in recent testimony before the Subcommittee on Securities, John Gutfreund of Salomon Brothers pointed to our "fragmented" financial system and its "morass of outmoded regulations" as obstacles to building strong domestic financial institutions.

As you have pointed out, Mr. Chairman, the competitiveness of all sectors of our economy is heavily influenced by public policy decisions. This simple fact is painfully clear to banks of all sizes as they try to cope with the realities of today's financial markets while they remain shackled by outdated laws and regulations. Revolutionary changes in technology have irrevocably altered the very nature of financial intermediation. Distinctions between products offered by different financial service providers have blurred, resulting in increased competition among banks, securities firms, insurance companies, and others for the business of financial consumers. And as technology pulls markets around the world closer together, competition from foreign financial institutions in both global and domestic markets is intensifying. Many of these trends are beyond the control of the government. But Congress can provide a legal structure that allows all players the flexibility to adapt and compete.

The increasing integration of financial markets offers many opportunities -- it opens new markets and it stimulates the creation of new and better products at lower cost to consumers. However, along with the benefits of increased competition, this integration also means that our banking industry faces stiff competition from institutions which often play by different rules. These differences in regulatory structure among financial service providers play a critical role in determining the winners and losers in competitive markets. Unfortunately, it is becoming more and more obvious that the laws and regulations under which American banks operate today condemn our industry to a losing role in both domestic and foreign markets.

Growing international competitive pressures have sparked a wave of regulatory reforms in other industrialized countries. This dynamic modernization is giving foreign financial markets and institutions a head start in developing innovative services to meet the needs of the future. A recent report entitled International Banking Competitiveness ... Why It Matters, prepared for the American Bankers Association, presents an in-depth look at recent events in Europe and Japan, and how they are likey to affect U.S. institutions and U.S. markets. As I will discuss more fully later in this statement, regulators in Europe and Japan are working toward broadening the product and service authorities of their institutions. The movement toward a united European Community in 1992 will make the universal banking charter the norm, allowing European banks to offer a full range of financial services without overly restrictive firewalls. And in Japan, which already has the 10 largest banks in the world, the Ministry of Finance is poised to liberalize Japanese banking laws to permit bank subsidiaries to engage in securities activities. These fully integrated and highly competitive foreign financial organizations will place U.S. banks and other U.S. financial firms at a serious disadvantage in both global and domestic markets.

Banks have already lost large segments of their traditional markets to other financial service providers in the United States. On the liability side, mutual funds, money market funds, cash management-type accounts, and insurance products have successfully attracted hundreds of billions of savings and investment dollars by offering combinations of products that banks cannot offer. On the asset side, securitization and commercial paper have allowed non-bank financial firms to perform many of the lending functions traditionally provided by banks.

The dramatic decrease in the competitiveness of U.S. banks has captured public attention. Because banks play such a critical role in a stable financial system, public concern over the declining position of American banks in domestic and global financial markets is well justified. A strong banking system is at the heart of a strong, growing economy. As the banking industry shrinks relative to its competitors, our financial regulatory system

-- designed to promote economic growth and stability -- will become less effective.

Losing our competitive edge in international financial markets also has serious consequences for the United States. The most immediate impact is a loss of jobs associated with international banking transactions. But the effects go way beyond this. Losing our financial leadership will also reduce the competitiveness and market share of other U.S. industries, especially export-oriented industries. It is sometimes argued that money owes no national allegiance and that U.S. firms will have the same access to credit whether they are dealing with U.S. banks or foreign banks. However, we live in an imperfect world and the market does not always operate according to text-book principles. Many governments look upon their banks as an integral part of their long-term export promotion strategy. There is, for example, an especially close partnership between Japanese banks and Japanese governmental authorities. It is no coincidence that the growing dominance of Japanese banks in the world's financial system has paralleled the growth of Japanese exports. The United States cannot remain a leading player in the emerging global economy and international political system if its banks are being swept aside in the competitive arena.

Equally important, a strong and healthy banking industry provides the best protection for our federal deposit insurance system. Failure to allow U.S. banks to compete may undermine the safety and soundness of our financial system and ultimately threaten the insurance funds. This is a serious risk that must be carefully considered by public policymakers as they determine the "proper" role for the banking industry in our financial system.

Ironically, the recent events in the savings and loan industry have been used by some to argue against allowing banks to offer a wider array of financial products and services. However, the lengthy and thorough public debate over the thrift crisis made it clear that product and service authorities were not responsible for the FSLIC crisis. In fact, two things are quite evident: first, the widespread insolvencies in the thrift industry were the result of regulatory failure -- in effect, desupervision; and second, the limited thrift charter which prevented meaningful asset diversification until the early to mid 1980s actually set the stage for disaster.

The limited thrift charter only worked well under relatively stable economic conditions, regulated deposit interest rates, and less integrated financial markets. But the combination of investment restrictions with changing economic conditions proved fatal. When interest rates peaked in the early 1980s, nearly all thrifts found themselves insolvent on a market value basis as the value of their long-term fixed-rate portfolios plunged. The regulators responded to the problem by virtually dismantling thrift capital requirements, allowing many institutions to operate with little or no real capital.

In short, by preventing the thrift industry from adjusting to its environment, the rigidities in the limited thrift charter actually laid the groundwork for the serious problem with which we are faced today. With no real capital at risk, thrift owners had an incentive to gamble on high risk investments -- and the regulators did little or nothing to discourage their excessive risk-taking or to close insolvent institutions.

The lesson to be learned from the thrift crisis is not that diversification is risky -- in fact, diversification clearly helps to reduce risk. The lesson of the thrift crisis is that regulators must rigorously enforce capital standards and must have an effective closure policy in place to deal with insolvent institutions. In addition to regulatory discipline, an increase in market discipline will enhance the safety and soundness of the banking industry -- and protect the deposit insurance fund -- by making it more difficult for badly managed institutions to grow, and by channeling funds to sound, well-managed institutions.

Two challenging tasks face policymakers as they begin work on restructuring our financial services framework. The first is to develop a flexible framework consistent with our unique national requirements which allows our financial institutions to be effective competitors in both domestic and global markets. The second is to maintain systemic safety and soundness and protect the taxpayer from underwriting the operating risks of our financial services system. These two goals are not in conflict -- a well designed program of comprehensive reform will achieve both.

II. The Need For Modernizing Our Financial Structure

Enormous changes are taking place in the global financial environment. Advances in data processing and electronic communications allow information and funds to be transferred within and across national borders almost instantaneously. The reduction in both cost and time associated with such transfers gives a wide range of market participants easy and cheap access to the same information simultaneously, facilitating the development of innovative financing techniques by non-traditional suppliers. These technological advances set the stage for a number of important general trends affecting financial service providers worldwide. These trends include:

- Blurring Product Lines

  Financial services have become commodities that can be provided by a variety of sources. For example, distinctions between financial products such as money market funds and deposit instruments are not easily discernable.

- Changed Intermediation Function

  The growth of institutional investors, especially pension funds and insurance companies, means that a large sector of the investment community does not need banks to act as traditional intermediaries. At the same time, securitization allows a wide range of borrowers to go to the capital markets for funds.

- Increased Domestic Competition

  Demographic, economic and technological events have reshaped the competitive environment, making traditional boundaries among financial service providers obsolete. Many nonbank providers can and do offer combinations of investment, insurance and bank-like products to both consumers and business customers.

- Increased International Competition

  Changing technology makes cross-border activity on a large scale feasible. Borrowers can search worldwide for the best source of financing, and creditors can diversify their financial activities among countries as well as across industries.

These trends have forever changed the types of financial products demanded and the way they are produced and delivered. They have resulted in increased competition and lower margins on financial products.

Competitive Position of U.S. Banks

U.S. financial firms, particularly banks, have not fared well in today's sophisticated global environment.

- As recently as 1983, two of the top three world banks ranked by assets were U.S. banks; now the largest U.S. bank ranks 24th (See Table 1).

- Ranking by market capitalization yields the same result -- no U.S. banks are among the top twenty financial firms in the world. The largest U.S. financial firm, American Express, ranked 21st; the largest U.S. banking organization, Citicorp, ranked 32nd (See Table 2).

- U.S. banks accounted for less than three percent of the assets of the top thirty banks at the end of 1988, down from 16.5 percent in 1983.

- In 1980, Moody's rated four U.S. banking companies Aaa; by 1988, no U.S. banking organization was Aaa-rated. The opposite trend is true for foreign banks; in 1980, two foreign banks were Aaa-rated, but by 1988 nine foreign banks were rated Aaa.

Competition from foreign financial firms has had a significant impact on domestic markets as well. As of June 1989, foreign-owned banking offices in the U.S. held 22.6 percent of total U.S. bank assets, up from 15.5 percent in 1982. Foreign-owned banks now account for 28.5 percent of the commercial and industrial loan market, and they dominate certain segments of the letter of credit business. Foreign-owned banks also compete successfully in the domestic deposit market; U.S. branches of foreign banks currently hold 17.3 percent of the total deposits of U.S. banks, up from 11.2 percent in 1982.

Perhaps most indicative of the future trends in foreign bank competition in the U.S. is the fact that foreign-owned banks are becoming increasingly important suppliers of financial services to American business. According to a 1988 survey conducted by Greenwich Associates, the average number of foreign-owned banks used by major American corporations rose to 5.3 in 1988, up from 3.2 in 1984. In contrast, the number of American banks used by U.S. corporations declined to 9.7 in 1988, down from 15.5 in 1984.

While growing international competition -- and the declining position of U.S. financial firms in the international arena -- clearly deserves the Committee's attention, legal barriers are also making it increasingly difficult for banks to compete with domestic financial service providers. Mutual fund companies, insurance companies, securities firms, and diversified corporations are taking advantage of more flexible regulations to offer a wide range of financial products and services that banks cannot match. They have been extremely successful competitors, and have gained considerable market share at the expense of commercial banks. The banking industry is not asking that restrictions be placed on banks' competitors; rather, we believe it is in the public interest to allow banks to compete freely and fairly with other financial service providers.

Banking's share of important domestic financial markets has declined steadily over the past 15 years as bank customers turn to nonbank firms for financial services. In 1974, banks held about 40 percent of the total financial assets held by financial institutions; today, they hold only 30 percent. In other words, banks have seen a quarter of their market share disappear since mid-1970 (See Chart I).

The obvious winners over the past 15 years are the nondepository financial service providers, including mutual funds, insurance companies, finance companies, real estate investment trusts, pension funds and securities firms. Because they are less restricted in the products they may offer, these financial service firms are able to develop new products and services that meet the needs of financial consumers while regulatory restraints keep banks on the sidelines.

In short, the declining market share of the banking industry reflects the movement toward new markets -- and away from traditional bank intermediation. For example:

- Mutual Funds
  In the 1980s, assets of stock, bond and income mutual funds grew at an annual rate of about 25 percent, while bank assets grew only about 9 percent (See Chart 2). Money market funds -- probably the most successful new financial instrument developed over the past decade -- grew from about $45 billion in January 1980 to almost $450 billion in January 1990 (See Chart 3). A good deal of this growth

undoubtedly came at the expense of bank deposit instruments, as depositors responded to the greater flexibility and greater range of investment opportunities available from mutual funds.

- Bank Lending/Securitization
  Recent advances in information technology have lowered transactions costs, shifting the cost advantage away from the traditional bank-type intermediation toward direct funding in securities markets. The impact of securitization is perhaps best known in the residential mortgage market (see Chart 4), but many financial transactions that originate as loans can be transformed into securities. The efficiency of this direct linkage between savers and investors through securities markets is enhanced because nonbank financial service providers are not subject to bank capital requirements, non-interest bearing reserve requirements and deposit insurance premiums. The potential for continuing securitization is enormous.

- Commercial Lending/Commercial Paper
  Commercial lending has traditionally been the most basic function of commercial banks. Today, however, banks are losing more and more of this business to the commercial paper market. In 1970, commercial lending at large banks accounted for almost 80 percent of the total short-term credit of domestic non-financial corporations. By 1975, the share was about 70 percent; and by 1988, it was less than 43 percent (See Chart 5). Much of this market share was lost to commercial paper. Once used only by large corporations with high name recognition, the use of commercial paper has spread to much smaller corporations. With the use of credit enhancements, these smaller companies are finding that securities markets are an attractive alternative to bank loans. As the commercial paper market becomes increasingly accessible to smaller, lesser-known firms, community and regional banks will also begin to lose some of their most creditworthy business customers.

- Diversified Firms
  The favorable mix of economic and regulatory conditions has encouraged many firms to diversify into a broad range of financial services, often combining the sale of insurance, securities, real estate and banking products. Some of these firms -- such as General Motors, General Electric, and Sears -- began as nonfinancially based companies. While their public image remains associated with cars and light bulbs, the fact is that these companies -- and many other "nonfinancial" companies -- are very involved in the provision of financial services. In addition, companies like Prudential Insurance, American Express, and Merrill Lynch have substantially expanded their financial service offerings to include new lines of business in response to emerging market opportunities. These companies can and do offer innovative combinations of banking and other financial products and services -- combinations that banks cannot offer.

- Insurance Companies
  There is an increasing overlap between banking and insurance products. For example, stand-by letters of credit serve the same function as financial guarantees offered by insurance companies. Many life insurance products are essentially guaranteed savings products. Many insurance investments are indistinguishable from commercial bank loans. Like banks, insurers accept savings from people, invest those funds and return the money with interest.

In view of this brief look at some of the trends in important bank markets, it should come as no surprise that during the 1980s commercial banks grew more slowly than their competitors. The mutual fund industry tops the list with a compound annual growth rate of over 25 percent since 1980. At the bottom of the list is the banking industry, which grew only about 9 percent (See Chart 6).

The impact of these trends is not just limited to large institutions -- it is being felt by small banks and in small communities as well. For example, in many small communities, funds which previously were deposited in the bank are being invested through branch offices of regional securities firms, in annuities sold by the local insurance agent, or in mutual funds.

Securities firms are targeting small businesses as well as consumers. For example, Prudential-Bache and Merrill Lynch have each created small business oriented accounts combining the most frequently used bank services, including transactions (checking) accounts and loan services, with financial planning and investment services -- combinations banks cannot duplicate. These accounts have been very successful. The Merrill Lynch Business Financial Services division grew at a compound annual rate of 30 percent over the past three years. The Pru-Bache account, which offers pension-related services, has attracted over $1 billion in assets. Thomas Gray, Chief Economist at the Small Business Administration, summed up the competitive situation this way: "Banks have been attacked on all sides in the last few years. Until they get some regulatory easing, they are going to have difficulty competing."

The declining market share and inability to compete effectively in today's financial markets is reflected in the market valuation of bank stocks relative to their book value. Chart 7 compares the market-to-book value ratios for 24 industries. The comparisons are based on a survey of 1,000 companies conducted by Business Week magazine. Ninety-nine banks were sampled, including banks with assets over $2 billion, representing a cross section of geographic areas.

Compared to other industries, prices of bank stocks are very low relative to their book value. As Chart 7 shows, bank stocks are valued like those of a declining industry, making it difficult for banks to attract new capital. Even more ominous, the depressed value of bank stocks indicate that market participants believe the future growth and profitability prospects of the banking industry are very limited. This view, of course, has a very negative impact on the ability of banks to raise capital.

The Impact of the European Community's 1992 Program

EC 1992 is the shorthand term for the twelve-nation European Community's plan to create a single internal market by the end of 1992. Because an integrated financial system is necessary to facilitate the broader integration of the European economies, one of the major objectives of EC 1992 is to create a unified banking market by the end of 1992. EC planners make it clear that streamlining the banking system in the EC is not intended merely to benefit banks. Sir Leon Brittian, Vice-President of the Commission of the European Communities, said in a recent speech that the banking system reforms are intended to

> ...increase the competitiveness of European industry by giving it access to the cheapest most efficient and most innovative financial products in the world. This in turn will raise employment and living standards throughout the Community. I hope and expect that in the decade ahead new trends in banking services will originate first and foremost in the European Community, because we will have the most attractive market. So don't say you weren't warned!

The universal banking model of integrated financial services has been codified by the EC's second banking directive -- it will be the norm in Europe in 1992. The consolidation and strategic positioning occurring in financial markets will clearly accelerate as we approach 1992. Foreign firms will continue to join within and across industry segments and within and across country borders to take advantage of efficiencies. Redundant systems and personnel will be eliminated, thereby reducing costs. By broadening their customer base, financial firms will be able to make more efficient use of their distribution systems -- again reducing costs. And by expanding their markets, institutions will be better able to diversify risk.

U.S. banks will have difficulty competing in this new environment in Europe, and the ability of European banks to offer a broader scope of products and services in their home market will make them stronger competitors in the U.S. market as well. They will have the opportunity to lead the way in the creation of sophisticated new financial products designed to meet customer demands. And, because they have a wider range of risk diversification vehicles, they will be in a stronger financial position to compete aggressively in the U.S. market.

Modern communications technology makes it possible for foreign financial institutions to sell their less expensive, more comprehensive banking, insurance and investment services in the U.S. without establishing a brick and mortar presence in this country. Frankfurt and Tokyo are only a telephone call away. National boundaries will not stop businesses and even consumers from meeting their financial needs with the least expensive and most efficient alternatives available. U.S. financial institutions, especially smaller institutions, will find it increasingly difficult to compete unless our rules are modernized.

In sum, EC 1992 means that U.S. financial firms will face increasingly stiff competition both domestically and worldwide. Efficiency, flexibility, and development of expertise are critical factors for success in this environment. Modernization of our financial structure is vital for our financial institutions to compete domestically and worldwide in providing our businesses and consumers the products and services they want and need.

Financial Modernization in Japan

Article 65 of Japan's Securities and Exchange Act, which separates commercial and investment banking functions, is modeled after the U.S. Glass-Steagall Act. But while the concept of Article 65 seems similar to that of Glass-Steagall, there are in fact some very significant differences. Although Article 65 prohibits banks from directly engaging in underwriting/dealing in corporate securities, it does not restrict bank affiliation with securities firms -- Japanese banks may own shares in securities firms and vice versa. And although anti-monopoly laws forbid a Japanese bank to own more than five percent of a domestic securities firm, this restriction does not apply to bank affiliates. For example, Mitsubishi Bank together with its affiliates owns over 75 percent of the outstanding shares of Ryoko Securities; the bank itself owns its maximum five percent share and its 29 affiliates (such as Mitsubishi Heavy Industry and Tokyo Marine and Fire Insurance) own another seventy percent.

Japanese bank affiliations are not limited to securities firms. Most of Japan's large banks are members of an industrial group called a keiretsu. These groups, which include financial institutions as well as non-financial businesses, are linked together through cross-shareholding and integrated directorships. For example, the "Mitsuigroup" includes the Mitsui bank, securities firms, insurance companies, mining companies, construction companies, engineering firms, department stores and more. Effective control of each company is held collectively within the "family", and the presidents of the major companies meet on a regular basis to plan and coordinate strategy. These formal and informal linkages provide the keiretsu member companies with a diversified base to spread risk arising from the development of new products and entrance into new markets.

In short, while on the surface there are similarities between the regulatory structures of Japan and the U.S., there are in practice some very real differences.

There have been significant reforms in the Japanese financial system over the past ten years. Until the 1980s, Japan's financial markets were quite protected. As Japanese banks began to recognize that they had outgrown their domestic market, regulators initiated reforms to allow them to more effectively internationalize their operations. Steps were taken to deregulate interest rate controls on domestic deposits, establish a commercial paper market, and remove restrictions on the international flow of funds. These actions should help dilute the cost advantages Japanese institutions have traditionally enjoyed over U.S. banks.

Japanese financial regulators recognize that additional steps should be taken to make Japanese banks even more competitive in world markets. Currently, they are poised to create a new competitive advantage for Japanese banks by revising Article 65, which will remove the final barrier to more direct and less costly bank involvement in securities activities. Dissolution of Article 65 will make Japanese banks even stronger competitors in the future in both U.S. markets and in markets around the world. The revision of Article 65 will leave the U.S. as the only major country continuing to impose extensive product and service barriers among financial institutions.

III. Financial and Regulatory Structure

Financial modernization in Europe and Japan is not just a problem for our money center banks. Regional and community banks will be profoundly affected whether or not they have international operations. As we have seen, foreign banks have already captured a considerable share of our domestic banking business, especially our commercial and industrial loan market. Unless U.S. banks are given the means to compete, an even greater share of our business will go to foreign banks in the years ahead.

Foreign banks will be able to use the efficiencies generated by their universal banking operations abroad to cut the margins on their U.S. business even when they play under our more restrictive rules. For example, the broader scope of services foreign banks can offer in their markets outside the United States will help build a diversified earnings base that will allow them to raise capital more cheaply than U.S. banks. This will enable foreign banks to price their services below U.S. banks while still maintaining an adequate rate of return.

We have seen the effect of global competition on our domestic manufacturing base. The same pressures are operating on financial services. Just as local car dealers have to compete with Toyota and Volkswagen, U.S. community banks will soon find themselves competing with Sumitomo and Deutsche Bank.

Whether we like it or not, the financial services industry is moving towards a single global market. We can no longer afford the luxury of maintaining a financial regulatory system that is badly out of step with the rest of the world. To pretend that EC 1992 is merely an aberration is a prescription for a buggy-whip banking industry.

There is a growing consensus among participants in the financial services industry, Members of Congress, regulators, and the Administration about the need to modernize our financial structure. The specifics of how to accomplish this modernization are the subject of debate. The associations for which I am testifying today are working actively on specific approaches, but at this point my discussion must be somewhat general. However, let me outline some guiding principles.

First, while we should not blindly emulate the systems put in place by foreign governments, we must recognize that the U.S. can not insulate itself from events in foreign markets. Our financial institutions must be given the flexibility to provide a wide variety of financial products and services that will enable them to compete freely and fairly in the U.S. and in markets around the world if this nation is to remain a leader in financial innovation and if U.S. consumers are to enjoy the benefits of a responsive and efficient financial system.

Second, there must be sufficient flexibility in the system to allow all financial institutions -- securities firms and insurance companies as well as banks -- to respond to changing market realities. Each institution should be free to decide which products and services to offer based on customer needs, market characteristics, risk assessments, and efficient use of available technology, distribution systems, and personnel. A flexible financial system will ensure that consumers have the widest possible choice of products from a variety of financial service providers at competitive prices. In addition, a flexible structure capable of accommodating changing market conditions will prevent our financial institutions from being left behind as technology, demographics, and economic conditions change.

Third, regardless of the structural vehicle for offering expanded products and services -- universal banks, subsidiaries, affiliates, holding companies, etc. -- the regulatory structure should treat all financial service providers equally. In other words, regulation should apply to a specific function rather than to a particular type of institution. For example, to the extent possible a bank-affiliated insurance company should be regulated by the same agencies and operate under the same rules as an unaffiliated insurance company.

Fourth, the regulatory system should provide adequate safeguards to protect the deposit insurance system -- and ultimately the taxpayer -- from systemic risk. This does not mean that we can or should protect individual institutions from risk -- rather, we need systems in place to restrain the type of imprudent behavior that could weaken the system. Existing laws and regulations form a solid basis for protecting depository institutions from any losses incurred by an affiliate. It is critical that our efforts to protect the system do not destroy the benefits gained from expanded product and service authorities. We must not burden our financial institutions with unnecessary and costly restrictions which will decrease their efficiency and undermine their ability to compete in global markets. If the firewalls placed on our institutions are overly restrictive, we will not have accomplished much in our quest for increased competitiveness.

In sum, we need a financial system that is responsive to international and domestic competition; provides the necessary flexibility to adjust to today's and tomorrow's rapidly changing environment; regulates by function, not form; and provides adequate safeguards for our deposit insurance system, without undermining bank efficiency and competitiveness. We believe that the modernization we have recommended can be accomplished without overhauling the entire regulatory and supervisory structure. With relatively minor modifications, and with the use of functional regulation, the current regulatory framework is capable of accommodating the changes needed to make our financial system competitive.

III. Deposit Insurance Reform

As you know, Mr. Chairman, an in-depth study of the fundamental structure of the federal deposit insurance system is currently underway at the Treasury Department. The issues surrounding deposit insurance reform are of the utmost importance to bankers. Each of the associations I represent here today has submitted comments to the Treasury, and each continues to work toward the development of a system that will strengthen our financial structure and enable insured institutions to compete effectively in today's financial markets.

There are a lot of smart people from both government and the private sector looking at the issue of reform, and there will be a lot of ideas generated by the discussions over the next year. Let me just outline for you some of the basic factors our five associations think deserve close attention during the reform process.

We believe that the central problem with our system of federal deposit insurance is rooted in the FDIC's current method for resolving bank failures. By its words and actions, the FDIC has created the widespread impression that it stands ready to provide 100 percent guarantees to uninsured depositors. There have been only infrequent exceptions to this policy of de facto 100 percent deposit insurance coverage, and the exceptions have all involved smaller banks. This policy has resulted in the perception that some banks are "too big to fail". Clearly this creates unequal treatment of depositors at large versus small banks. It also undermines market discipline, since large depositors have little incentive to analyze the financial strength of the institutions in which they place their funds.

A policy of 100 percent deposit insurance coverage creates a number of serious problems:

- o To the extent total protection by the FDIC is confined to deposits at large banks, it discriminates unfairly against smaller banks and their uninsured depositors.
- o It undermines the incentive for large uninsured depositors to carefully evaluate and monitor the financial condition of the banks in which they place their funds.

- It gives poorly managed institutions too much freedom to gamble with insured deposits without paying the costs of the risks they incur.
- It entails an enormous and unnecessary commitment for the FDIC and ultimately for the taxpayer.
- A 100 percent government guarantee would place the entire burden of monitoring the financial condition of the banking industry on the regulatory agencies. This will undoubtedly lead to increasingly burdensome regulation, and will contribute to the perception and treatment of banks as public utilities.

Each of the five trade associations I represent here today agrees that these results are detrimental to the banking industry. We therefore believe that 100 percent deposit insurance -- de facto or de jure -- is not acceptable.

The alternative is a federal deposit insurance system which encourages market discipline. Uninsured depositors should share in the risk of failure of the institutions in which they place their funds. As uninsured depositors make more careful assessments of their exposure to loss, poorly managed institutions will be forced to pay higher interest rates to attract funds, limiting their ability to grow. Over time, an increasing share of the banking business will be channelled to well-managed, sound institutions.

For market discipline to work, the current "too-big-to-fail" policy must be renounced. No bank -- large or small -- should be too big to fail, and no large uninsured depositor should be granted full coverage if the FDIC suffers any losses in resolving the failure. The biggest obstacle to implementing a system incorporating market discipline in the past has been the lack of a resolution framework capable of handling a large bank insolvency in a timely and orderly manner without causing severe disruptions to the financial system. Development of such a framework is a difficult problem -- but it can now be done.

Many of the current difficulties involved in handling a large bank failure are administrative and technological. Some of the more difficult elements involved, including domestic payments and international settlements questions, are currently being dealt with in another context. With proper advanced planning, systems can be put in place that will minimize operational problems in resolving an insolvent institution.

A system in which uninsured depositors share in the losses of insolvent institutions will be less costly to the FDIC. First, the FDIC's obligations in a failure resolution would be directly reduced to the extent that uninsured depositors share in the loss. And second, because increased depositor vigilance will direct the flow of deposit funds to sound, well-managed institutions, the entire banking system will be stronger and the number and size of bank failures will be minimized.

The banking industry is anxious to work with Congress, the regulators, and the Treasury to develop and implement a program that will allow the FDIC to renounce the "too-big-to-fail" policy and embrace a system based on market discipline that treats depositors at all banks fairly and equally.

On the issue of deposit insurance coverage, we do not believe that it is in the public interest to change the current level from $100,000. The current level is widely understood and accepted by the public. Moreover, many consumers and small businesses have based their financial management plans around the current level, and change would be costly.

Finally, I would like to discuss whether there should be linkage between financial restructuring and deposit insurance reform. We agree that deposit insurance reform is an important issue that should be addressed by the Congress. We also agree that the Congress should pass legislation making our banking and financial system more competitive. But we do not agree that these two proposals must necessarily be bound together.

It is both feasible and desirable to move toward a stronger and more competitive banking system even if an early agreement cannot be reached on deposit insurance reform. The issue of deposit insurance reform is both difficult and controversial, and it is by no means clear that a consensus is near. There is, however, a growing consensus that overly restrictive banking laws no longer serve a legitimate public purpose.

We challenge the notion that allowing banks to offer a wider variety of financial services to their customers creates more risk for the deposit insurance fund. Foreign banks have engaged in securities and insurance activities for years. Many U.S. banks have extensive securities operations overseas. U.S. banks have also been allowed to underwrite certain securities within the bank for years, and more recently some banking organizations have been authorized to conduct certain securities activities through holding company affiliates. Many state-chartered banks are exercising insurance powers. There is no evidence that any of these activities is inherently riskier than traditional banking activities.

In fact, we would go one step farther and argue that the riskiest of all policies is to do nothing on financial restructuring. If Congress does not allow banks to compete in the broader market for financial services, banks will continue to lose business to their non-bank competitors as well as foreign banks. The inevitable result will be a weaker, less diversified banking system. While the financial market place continues to develop new alternatives to traditional banking products, banks will be left with making ever more marginal loans to borderline borrowers. This is a prescription for more risk to the deposit insurance fund.

We hope this Committee and the Congress can tackle all the issues on its agenda. But if progress stalls on the deposit insurance front, we urge this Committee to complete the financial modernization task it began in 1988.

IV. Other Regulatory Issues

Mr. Chairman, your letter of invitation asked us to comment on the proposal to merge the Office of Thrift Supervision (OTS) into another agency such as the Office of the Comptroller of the Currency. We believe that this proposal is premature. There have been tremendous regulatory changes in the thrift industry over the past year as a result of FIRREA. We believe that the potential for harm resulting from further confusion and disruption in the thrift regulatory system out-weighs any benefits that might be gained from such a merger at this time.

Moreover, we believe that the form of the regulatory agencies should flow logically from the structure of the industry. Quite frankly, it is not clear at this time what the ultimate structure of the thrift industry will be. Before we attempt to fashion a government reorganization of the regulatory agencies, fundamental questions as to the future role of the thrift industry should be answered.

Merging OTS into the Office of the Comptroller raises several jurisdictional questions as well. For example, what agency would regulate a savings and loan holding company? In the banking industry, that role belongs to the Federal Reserve regardless of which agency regulates the insured depository institution. What about state chartered savings institutions? Would they be regulated by the Comptroller? Under the bank regulatory model, federally insured state chartered institutions are regulated by state authorities and the FDIC, not by the Comptroller. Federal regulation of a state chartered depository institution would run contrary to the spirit of the dual banking system.

The dual banking system has served this country well over the years. States have historically chartered depository institutions and determined the activities in which they are allowed to engage. This system has allowed states to function as "laboratories" for developing new products and services for depository institutions, such as NOW accounts. We do not believe it would be in the public interest to erode this unique partnership between federal and state authorities by placing state chartered savings institutions under the Comptroller.

V. Conclusion

The time has come for the United States to chart the future of its financial services industry. Precious time was lost during the 1980s. Failure to act has undermined the foundations of our industry while developments in Japan and Europe have strengthened our competitors way beyond what one would have believed possible a short decade ago.

The vitality and safety of a nation's financial system lie at the core of its economic well-being. Not only do our financial institutions perform the savings, credit, investment and payments functions of our economy, but these institutions are important vehicles through which our country projects its influence beyond our borders. We must assure that we are competitive in the global markets and that our financial institutions can effectively and efficiently serve the needs of our domestic economy.

Mr. Chairman, your leadership is urgently needed to develop a national policy with respect to financial services and a politically feasible action plan to achieve that policy. I pledge my own commitment as well as that of my colleagues at Chase to work with you and others to address these important concerns.

Table 1

THE WORLD'S TWENTY LARGEST BANKS RANKED BY ASSETS

December 31, 1988*

	Number of Banks in Top Twenty	
Country	**1983**	**1988**
United States	3	0
Japan	8	15
France	4	3
United Kingdom	3	2
Germany	1	0
Canada	1	0

	Firm	Country
1.	Dai-Ichi Kangyo Bank Ltd	Tokyo, Japan
2.	Sumitomo Bank Ltd	Osaka, Japan
3.	Fuji Bank Ltd	Tokyo, Japan
4.	Sanwa Bank Ltd	Osaka, Japan
5.	Mitsubishi Bank Ltd	Tokyo, Japan
6.	Industrial Bank of Japan Ltd	Tokyo, Japan
7.	Norinchukin Bank	Tokyo, Japan
8.	Tokai Bank Ltd	Nagoya, Japan
9.	Mitsui Bank Ltd	Tokyo, Japan
10.	Mitsubishi Trust & Banking Corp	Tokyo, Japan
11.	Credit Agricole Mutuel	Paris, France
12.	Sumitomo Trust & Banking Co., Ltd	Osaka, Japan
13.	Banque Nationale de Paris	Paris, France
14.	Barclays Bank Plc	London, U.K.
15.	Mitsui Trust & Banking Co., Ltd	Tokyo, Japan
16.	National Westminister Bank Plc	London, U.K.
17.	Credit Lyonnais	Paris, France
18.	Taiyo Kobe Bank Ltd	Kobe, Japan
19.	Bank of Tokyo Ltd	Tokyo, Japan
20.	Long-Term Credit Bank of Japan	Tokyo, Japan

Source: American Banker, July 25, 1989.

* The largest U.S. bank, Citibank, ranked 24.

Table 2

THE WORLD'S LARGEST FINANCIAL FIRMS RANKED BY MARKET CAPITALIZATION*

October 1989

	Firm	Country	Market Capitalization ($ billions)
1.	Industrial Bank of Japan	Japan	$86.2
2.	Sumitomo Bank	Japan	67.9
3.	Dai-Ichi Kangyo Bank	Japan	66.9
4.	Fuji Bank	Japan	61.5
5.	Mitsubishi Bank	Japan	60.7
6.	Sanwa Bank	Japan	50.6
7.	Nomura Securities	Japan	45.6
8.	Long Term Credit Bank	Japan	34.1
9.	Tokai Bank	Japan	33.2
10.	Mitsui Bank	Japan	32.6
11.	Mitsubishi Trust	Japan	25.2
12.	Taiyo Kobe Bank	Japan	24.6
13.	Bank of Tokyo	Japan	24.1
14.	Sumitomo Trust	Japan	23.2
15.	Daiwa Securities	Japan	21.7
16.	Nippon Credit Bank	Japan	19.7
17.	Nikko Securities	Japan	18.8
18.	Daiwa Bank	Japan	16.9
19.	Mitsui Trust	Japan	16.1
20.	Yamaichi Securities	Japan	15.5

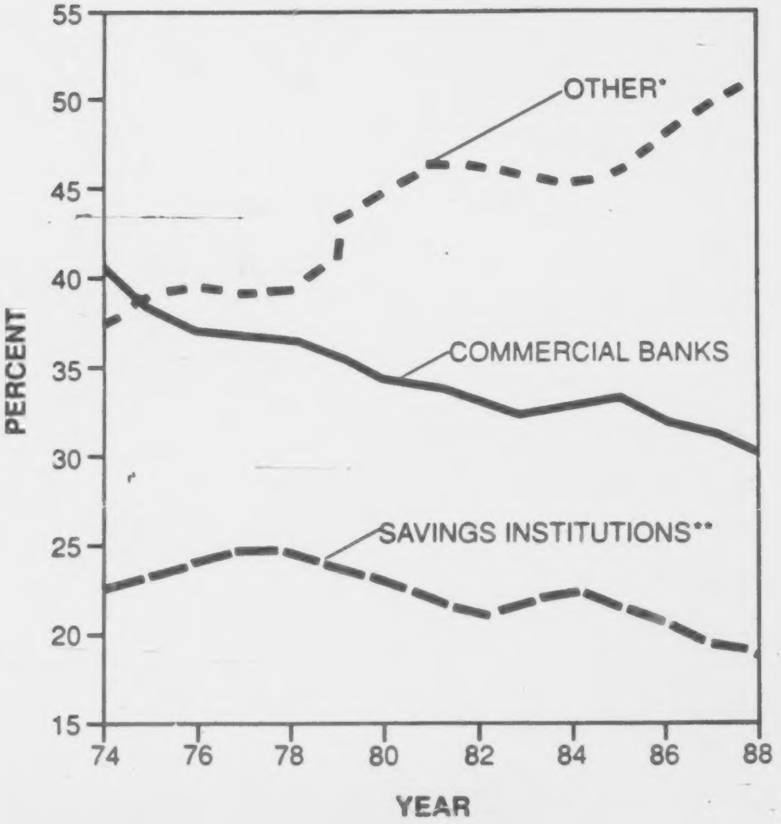
Source: Morgan-Stanley, Capital International Perspective.

* The largest U.S. financial firm, American Express, ranked 21 ($15.2 billion).

The largest U.S. banking organization, Citicorp, ranked 32 ($9.5 billion).

In the U.S., the Market Share of Commercial Banks Has Steadily Eroded Over the Past 15 Years.

Chart 1
Market Shares of Financial Assets Held by Financial Institutions



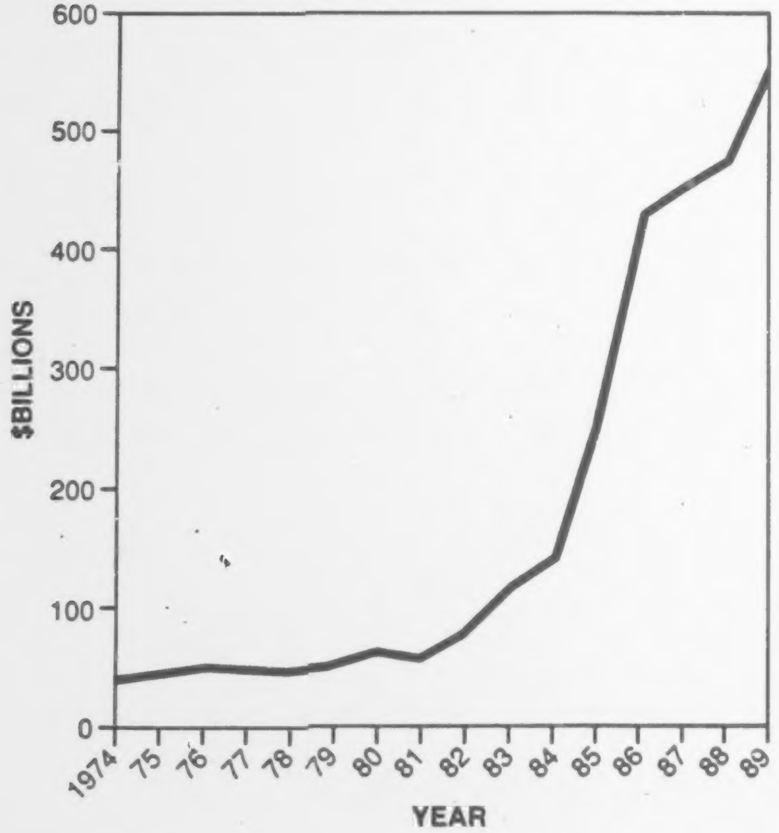
***Savings and Loan Associations, Savings Banks, and Credit Unions.*

**Insurance companies, Pension funds, Finance companies, Real estate investment trusts, Money funds, and Securities brokers and dealers.*

Source: Federal Reserve Board, Flow of Funds Accounts.

In the 1980s, Hundreds of Billions of Dollars Flowed Out of Banks and Into Securities Products.

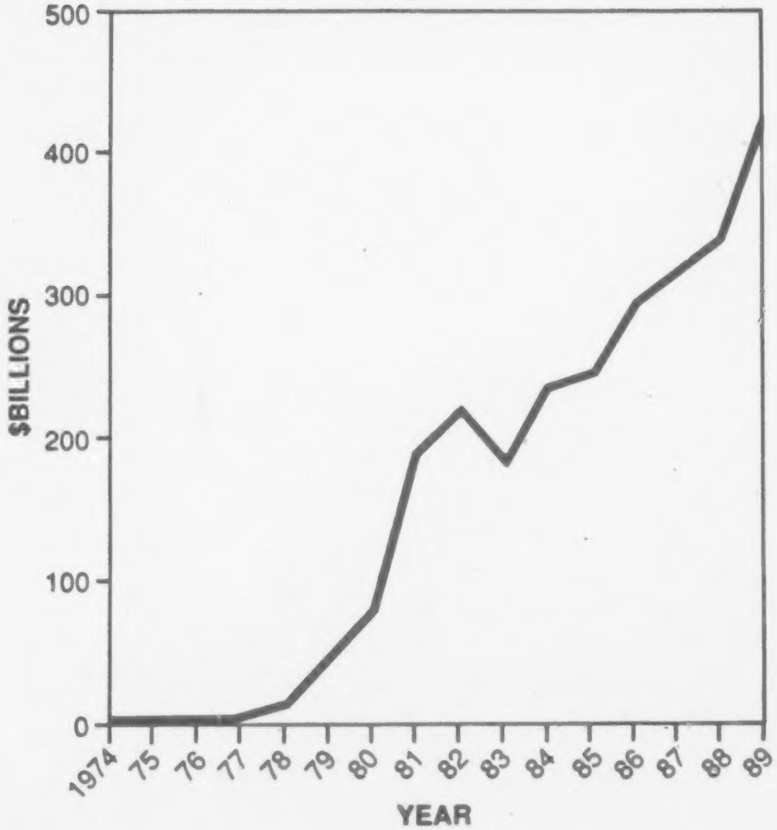
Chart 2
Mutual Fund Assets



Source: Investment Company Institute.

The Explosive Growth of Money Market Funds Reflects Their Ability to Link Investment Products Such as Brokerage Accounts and Families of Mutual Funds.

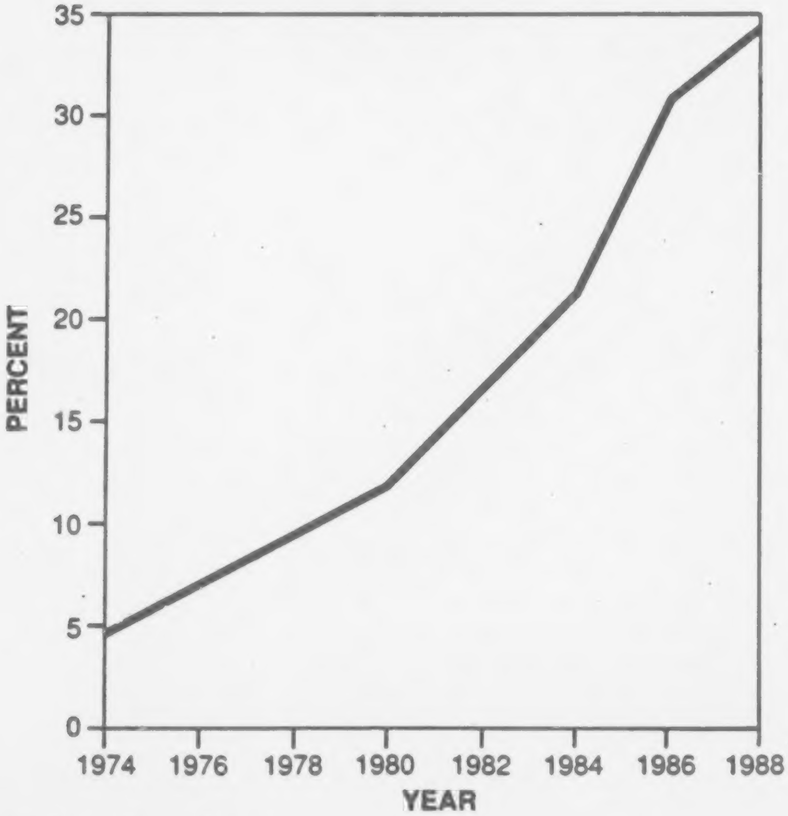
Chart 3
Money Market Fund Assets*



**Figures are totals for money market and short-term municipal bond funds.*
Source: Investment Company Institute.

The Securitization Process Has Had a Huge Impact on Traditional Bank Lending Markets. For Example, A Growing Percentage of Residential Mortgages Are Now Securitized.

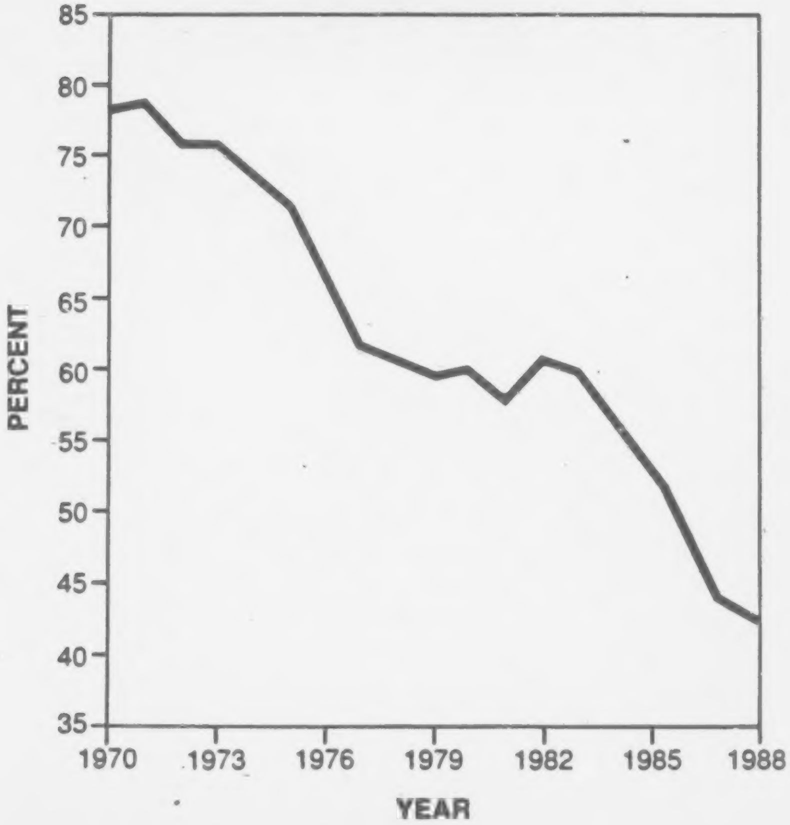
Chart 4
Mortgage-Backed Securities Outstanding as a Percent of Total Residential Mortgages Outstanding



**Source: Federal Reserve Bulletin.*

More and More Businesses Now Borrow Through the Commercial Paper Market Rather Than From Banks.

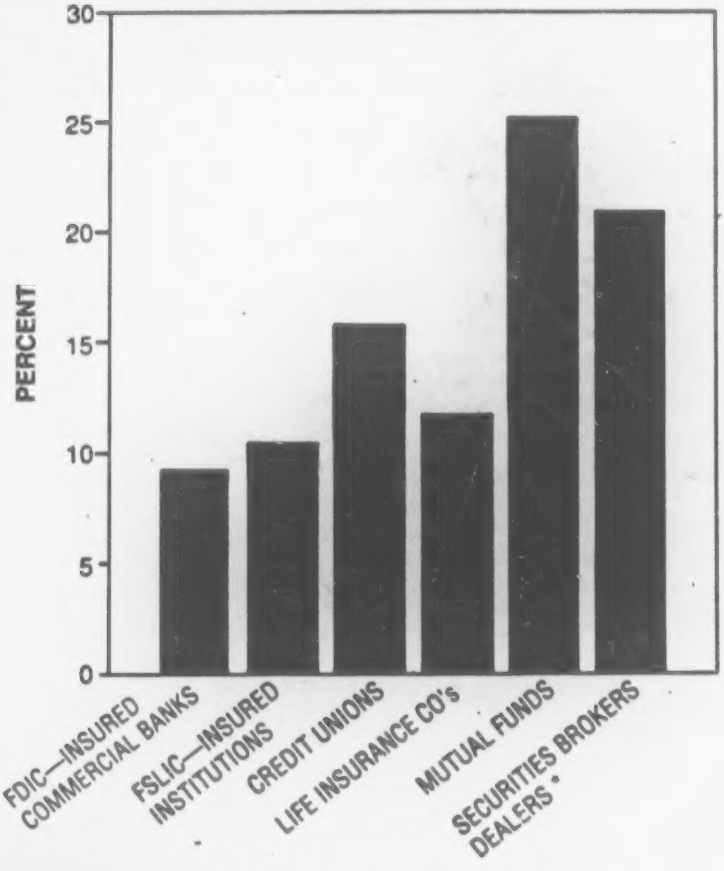
Chart 5
Large Bank Commercial Loans as a Percent of Total Short Term Borrowing of Nonfinancial Corporations



**Includes bank loans, commercial paper, bankers' acceptances, and finance company loans.*
Source: Federal Reserve Bulletin, Flow Of Funds.

It Is Not Surprising That in the 1980s, Commercial Banks Grew More Slowly Than Any of Their Competitors.

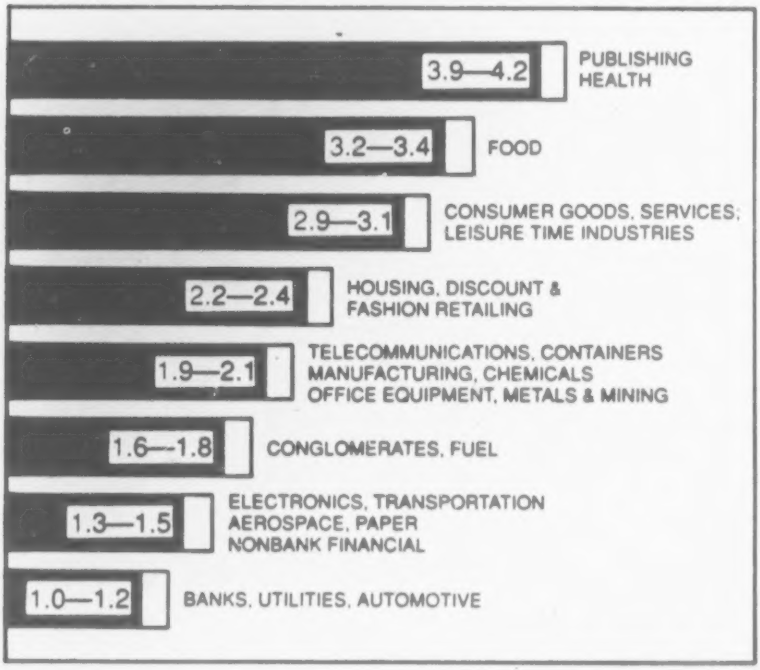
Chart 6
Compound Annual Asset Growth Rates of Financial Institutions 1980-1988



** September 1988.*
SOURCE: FDIC, FHLBB, NCUA, ACLI, ICI, NYSE.

The Competitive Situation Facing the Banking Industry Is Recognized By the Stock Market. Bank Stocks Are Valued Like Those of a Declining Industry, Making It Difficult for Banks to Attract New Capital.

Chart 7
Industry Market-to-Book Ratios 1988*



** SHARE PRICE AS OF MARCH 17, 1989/BOOK VALUE PER SHARE OF COMMON STOCK*
SOURCE: BUSINESS WEEK'S TOP 1000, 1989.

The **Chairman**. Thank you, Mr. Labrecque. We have been joined by other Senators. Let me ask Senator Bond if he has any initial comment he would like to make.

Senator **Bond**. Well thank you, Mr. Chairman. I am certainly impressed by the distinguished witnesses we have before us today. Both have broad experience in the financial services industry, and both of their proposals have much to commend them.

I am struck by how the focus of Mr. Downey's proposal seems to be on reducing potential government liability due to deposit insurance with little mention of the international competitiveness of our financial institutions, while Mr. Lebrecque's proposal focuses on competitiveness with no mention of government exposure. It seems to me these are both worthy goals, and when we deal with this subject we are going to have to reconcile them.

I thank you, Mr. Chairman.

The **Chairman**. Thank you, Senator Bond.

Senator Sasser.

Senator **Sasser**. Thank you, Mr. Chairman.

I want to compliment you, Mr. Chairman, for your leadership on the issue of modernizing our financial system, and in moving so quickly to schedule this hearing with these very important witnesses.

Now, Mr. Downey, I want to take this opportunity to admonish you and your organization for making our jobs here on the Banking Committee more difficult. This used to be a very easy issue for us to deal with. The commercial banks wanted to be in the securities business, and all the investment banks cared about was keeping the commercial banks out. But now the world has turned upside down.

For most of my 8 years on this committee, Glass-Steagall was viewed to be an immovable barrier, and section 20 was merely a footnote to the National Banking Act. But now the SIA actually wants to repeal Glass-Steagall, and would actually permit banks to affiliate with securities firms.

Now if we think what has happened in Eastern Europe is mind-boggling—[laughter]—I think it pales to insignificance when you compare what has happened there to what is on the verge of happing in the financial services industry.

Well, seriously, I think the SIA ought to be complimented for the sophistication and thoughtfulness of your proposal. It is a new approach at an issue that really has become quite, quite complex.

Mr. Chairman, I have a prepared statement which I would like to have included in the record. I will not give it due to the tardiness of my arrival this morning. I had two other committee meetings to go to.

The **Chairman**. Very good, Senator Sasser. We will make that part of the record.

OPENING STATEMENT OF SENATOR JIM SASSER

Senator **Sasser**. Mr. Chairman, I want to compliment you on your leadership on the issue of modernizing our financial system, and in moving so quickly to schedule this hearing with these important witnesses.

Mr. Downey, I also want to take this opportunity to admonish you and your organization for making our jobs here on the Banking Committee even more difficult.

This used to be a relatively easy issue. The commercial banks wanted to be in the securities business. And all the investment banks cared about was keeping the commercial banks out.

For most of my 8 years on this committee, Glass-Steagall has seemed to be an impenetrable barrier. Section 20 was merely a footnote in the National Banking Act.

But now the SIA seeks the repeal of Glass-Steagall and would permit banks to affiliate with securities firms. You actually have your own proposal.

Seriously, the SIA should be complimented for the sophistication and thoughtfulness of its proposal. It's a new approach at an issue that really has become quite complex.

Instead of dealing with what used to be a relatively black and white situation, we must now address critical concerns such as if banks and securities firms affiliate, what are the appropriate firewalls, what's an adequate level of capital, and who shall regulate what, among others.

Since the time that this committee last voted on this issue, we, fortunately or unfortunately, have had a very active regulator in the Federal Reserve and the Federal courts. But the Fed's actions have benefited only the largest banks. And I think it's highly questionable whether the taxpayers are better off with lawmaking by loophole.

After all we are in the middle of the greatest financial crisis since the 1930's. And this crisis—the S&L bailout—is largely a failure of the regulatory system.

Now as we approach the issue of restructuring financial services, we must make sure that we have the absolute best system to protect the taxpayers. I have many concerns. The policy of "too big to fail" has been too pervasive in our banking system in recent years. It is not only unfair, it exposes the taxpayers to too much risk. Certainly, the Government can't be rescuing banks and securities firms.

Moreover, I don't think that we should rush to conclusions because something may seem to work well overseas. Indeed, I still think there was a good reason for the separation of banking and commerce here. And I don't think that size is the answer. The Japanese banks may be the biggest, but they're not necessarily the most profitable.

And last, no other country has quite the same system of deposit insurance that we do. So as long as we have the U.S. Treasury and taxpayers standing behind ours, I think we have to be very cautious in our approach to this issue.

Mr. Chairman, I look forward to the testimony of the distinguished witnesses. Thank you.

The **Chairman**. Senator Dixon.

OPENING STATEMENT OF SENATOR DIXON

Senator **Dixon**. Mr. Chairman, as I understand it this is the first in yet another series of hearings on modernizing financial services law. I wish I could say that I am pleased to be here, but the truth is that what I am is frustrated—frustrated because in my 10 years in the Senate there has been no progress on these issues.

In 1984, the Senate passed a bill providing banking organizations with three security powers by a vote of 89 to 5. In 1988, the Senate acted on a more comprehensive approach to the securities issues by an even more overwhelming vote of 94 to 2. Unfortunately, neither bill became law.

The failure of our colleagues in the House to address financial modernization issues, as the Senate has now twice done, has meant that the regulators and the courts have assumed control of the process. The reform process was not stalemated. There was and is too much demand for change. Frankly, I am embarrassed that we have allowed courts and regulators to assume policy-making responsibilities that belong to the Congress. We do not have the luxury, however, of not addressing financial reform issues.

The only way for Congress to restore its rightful place in the process is for us to act. We now have an additional reason that compels action: the rising tide of international competition. Foreign banks are rapidly increasing their presence in our markets. Many of these banks can provide a much greater variety of services for their U.S. customers than our banks can. They may have to perform some services offshore, but that hardly seems like a fatal liability.

The net result therefore is that the need for reform is even more compelling now than it has been in the past. Unless we act soon, both the U.S. banking industry and the U.S. securities industry are likely to be increasingly disadvantaged vis-a-vis their foreign competition in the American market.

I thank the Chair.

The **CHAIRMAN**. Thank you, Senator Dixon.

Let us start on the questions now.

Mr. Labrecque, on page 9 of your testimony you say that U.S. banks will have difficulty competing in Europe after the adoption of the single banking license in 1992. My question is: If U.S. banks receive national treatment in Europe and European banks in turn receive national treatment in the United States, what competitive disadvantages then do U.S. banks suffer?

EQUAL TREATMENT HERE AND ABROAD

Mr. **LABRECQUE**. Senator, I think there are a number of issues here. It is critically important that we be on equal footing in those foreign countries with their institutions, and critically important that we be on an equal footing with those institutions in our own country.

The best way to answer your question is to give you an illustration. Two years ago, Chase put together a financing package for a German subsidiary of an American company. That package was a complete restructuring that included debt, bank financing, and equity, products which we are allowed to offer in Germany, and we are allowed to offer them in a number of other places in the world and do. That winning proposal was turned over to the Deutsche Bank by the German subsidiary of an American company to execute for them. The reason was that the German banks, which happened to be Deutsche, could distribute the equities in the United States and we could not.

What the American banking system is saying is: We want equal treatment in their market, and we want equal treatment in our market. Our customers are demanding those services. We are providing them worldwide, and we have the skills and talent to do it.

As a matter of fact, when I look at the number of people I have lost to Wall Street, I know we have the skill and the talent to do it.

The CHAIRMAN. Is that not an argument, in effect, for a sort of a global, universal banking structure? Is that what you are really asking for here? Are you really saying, let us have one system that in a sense rides over international boundary lines so that we really have one kind of global, universal banking system? It sounds to me like that is where you are heading.

Mr. LABRECQUE. Where I am heading is not necessarily, for one system. I am heading and the industry is heading for the ability to compete, for us to create a system in our own country which allows us to compete equitably within our own country and with competition coming from outside our own country.

There have been two or three models proposed—including the universal bank model, the financial services holding company model—and those I think should be debated. But clearly what we want, and what American industry needs, is the ability to compete both domestically in our own country and with foreigners in our own country, as well as with foreigners in their own land.

The CHAIRMAN. Let me ask you a related question, and then I will see if Mr. Downey wants to react to either of these points. You talked earlier in your statement about the size of other international banking institutions. If you compare them on profitability, despite the size of the Japanese banks, as you know Japanese banks' profit margins in the United States are not as large as those of U.S. banks. Looking worldwide, U.S. banks are the most profitable according to a survey conducted by the IBCA, a bank rating agency. That study showed that U.S. banks account for 26 out of the world's top 50 most profitable banks.

I think it raises the question: If U.S. banks are more profitable than foreign banks, why should we be concerned about U.S. banks' ability to compete in securities and insurance services and other things? How do we account for that very strong profitability performance?

Mr. LABRECQUE. I think, Senator, there are a couple of issues.

First of all, I think what American institutions are saying is they want to be able to deliver to their customers what their customers want. Now there is no question that is measured by return on assets in what we can do, and measured by return on equity in what we can do, American institutions in the profit measures do quite well. That is correct.

But look at what our competition, especially the Japanese, are doing. Remember that no one ever accused the Japanese of having the best profit potential, or profit numbers, when they were beginning to build market share in any other industry—whether it was automobiles or whether it was semiconductors. They are willing to give up profit for long-term market share, and I think they are doing it in banking too.

The CHAIRMAN. Let me just quickly ask Mr. Downey. Do you have any comment that you want to make before I yield to Senator Garn?

Mr. DOWNEY. Very quickly on the universal banking issue, Mr. Chairman, what might be right for Germany might not be right for us as a nation. I think that is a very large question. If we go all the way with universal banking, do we want the chairman of Citicorp to be also the chairman of General Motors, the way the chairman of Deutsche Bank is also the chairman or the spokesman for Daimler-Benz. That is a very large question for the Congress to mull over—if that is the only way to compete.

What our proposal does—and with due respect to Senator Bond—we may have emphasized the concern of deposit insurance perhaps more than international competitiveness; we did not mean to, but it may have just come out that way—but truly our plan says: Use universal banking, if that is what banks need to compete, or feel they need to compete, but let's just not have Uncle Sam as part of that equation.

On the other issue, very quickly, on the profitability issue, and I am not enough of an expert to say whether market share, or market capitalization, or profitability is more or less important, but I think it is very clear that the lack of a Glass-Steagall Act in Japan is certainly not why the banks are strong or the securities firms are strong there. They have a stronger Glass-Steagall Act than we do, article 65, and the banks have flourished and the securities firms have flourished, and frankly Japan's markets have flourished until the last 2 or 3 months.

The CHAIRMAN. Senator Garn.

Senator GARN. Thank you, Mr. Chairman.

Over the 15 years that I have been discussing these issues with many people who I see in the audience, there are not too many new faces out there, we are all the same old cast of characters dealing with this, to those who have opposed modernization as I prefer to call it, and others want to call it "deregulation" because that gives a bad twist in many circumstances, there has always been some reason why we should not do something.

I think it has been adequately pointed out by most of my colleagues that many of the things we have talked about have occurred, but they have occurred in the States, they have occurred in the courts, they have occurred with the regulators, and Congress simply has not set any policy. So all the things that people did not want to have happen, have happened. I still think they would have been much better off to work for some national policy that was uniform.

But the latest excuse is, obviously, why in the world have you not learned from the lessons of the savings and loan crisis? How could you possibly talk about modernization in this environment? And should we not be going in the other direction and restricting as a result of this?

What is your comment, both of you, to that line of thinking that because of the S&L problem we should be reregulating and going backward rather than forward?

Mr. LABRECQUE. Would you like me to go first?

Senator GARN. Either one of you is fine.

REREGULATION?

Mr. **Downey**. Senator, I think that is a very good question, and there may even be a temptation to use that approach. But we are not unmindful of the international competitiveness issue that has been raised rather eloquently by our banking colleagues. The fact that there needs to be a stronger competitive approach by our banks is something that we recognize. So we think that that is overriding.

The simple thing would be to keep Glass-Steagall. It is so interesting to hear from our Japanese colleagues, the Numora's and the Yamaichi's and so forth. They sound like us 10 years ago. They are stronger than ever; let's hold the line forever. But our view is, maybe there is a way to do this, and this is what we tried to do in our plan, which is radical, which allows what the banks want—which is to be able to combine securities powers and commercial banking powers in one unit—but also to keep Uncle Sam out of the equation. We think that that system can be developed and work.

But we are not superconfident. We could get blown away on this if somehow the "too big to fail" approach were to remain, even in that system. We would definitely be the underdogs. But we are prepared to face that problem.

Mr. **Labrecque**. Senator, just a comment on the deposit insurance and "too big to fail."

What we are saying is no one should be too big to fail. What we are saying is that deposit insurance should not go beyond $100,000, and we should be restricting it and therefore dealing with the contingent liability.

Let me come back to your fundamental question. I look at the savings crisis as one that has a much longer history than most. I wasn't in this business 10 years when a Presidential Commission called the Hunt Commission produced a report, a report that I believe nobody wanted to see. But it eventually came out at the end of Lyndon Johnson's Presidency. I think if people were to go back and read that report, they would see that it said, that the role of the savings industry, particularly in an inflationary environment, was going to be very difficult.

The recommendation was that savings and loans be allowed to become commercial banks, or be the real estate lending departments in an insurance company, but clearly that in an inflationary environment there had to be change. We did not change. And then, we inflated. We begrudgingly changed regulation Q. We eventually made S&L's unprofitable. And then, instead of restructuring the industry correctly, we tried to put bandaids around it. So we ended up with a situation where we kept reaffirming deposit insurance, we kept reaffirming 100 percent deposit insurance, and we didn't restructure.

What we are saying here is, let's not make the same mistake again. We do have an issue. We should confine deposit insurance. But we should also look at what the customer wants, and we should let people be able to provide it, and provide it on the same footing.

Let me, if I might, respond on one other point that has been made twice here and I think it is very important. People talk about

Japan and article 65, their Glass-Steagall. For the record I would like to read a set of investments of the Sumitomo Bank Ltd. People keep saying Japan has a Glass-Steagall in article 65. They do. But what they are allowed to do under it is considerably broader than what we are allowed to do.

Sumitomo Life is an investment of Sumitomo Bank Ltd. Sumitomo Marine and Fire, Daiwa Securities, Nikko Securities, each of these are at least a 5-percent investment of Sumitomo Banks, and the other companies in the Sumitomo group own the other major pieces. And no one has said, let's build firewalls so they cannot deal with each other. That same Sumitomo Bank, through a Delaware subsidiary, has a major investment in Goldman Sachs. I can guarantee you, ladies and gentlemen, Sumitomo has not stopped doing business with the customers of Goldman Sachs.

Senator **Garn**. Mr. Chairman, let me just sum up the responses to my question.

First of all, Mr. Labrecque, you're absolutely right. To those, as I have read stories about the S&L crisis in the last year, it has been dealt with so superficially and so lightly in terms of the fact that, if you came from another planet and simply read the accounts the last year, you would think that this all occurred in the last couple of years, or 3 years at the most, with no background, starting with the Hunt Commission report.

Lud remembers all the years we sat together and labored over the reports in the later years of the Carter administration into the Reagan administration, and the history of many, many people who were talking about the coming crisis in the S&L industry if we didn't modernize and restructure.

So I agree with you completely.

The other point I would make in answer to my own question, I think the thing that is important is that we have to differentiate between activities that are conducted by separately capitalized affiliates, and activities that are conducted directly by an insured institution.

That gets back to what you're both talking about, a deposit insurance. Certainly, deposit insurance was never intended to be used at whatever level, whether it was $10,000, $15,000, $40,000, or $100,000.

That level is not nearly as important as saying that one person gets to go to $100,000 rather than the multiple accounts, and the way it was expanded in getting into your argument of too big to fail.

And so I think it's important that we note that all the restructuring bills I've been involved with have separated these activities and said it should be in a separate affiliate even to the point of going too far, in my opinion, sometimes of not even being able to allow that affiliate to use the name of the parent organization, so that you didn't get people in on that basis.

I think we need to make that distinction from the background and history of the S&L crisis, and then whatever we do, we must separate that deposit insurance function from these activities. And, obviously, there can be argument about how those firewalls are drawn.

But, I think those principles are important in this debate.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you. We've had a vote start. We have time for Senator Sasser, and let me call on Senator Sasser.

Senator SASSER. Thank you, Mr. Chairman.

Gentlemen, as I look at all the activities that bank holding companies are involved in today, it seems to me that at least as far as the large banks are concerned, they are involved in every type of securities activity.

The banks have moved into these areas as a result of court decisions and as a result of regulatory decisions.

As I see it, bank holding companies can now underwrite corporate debt, junk bonds, mortgage-backed securities, revenue bonds, commercial paper, and so forth.

Now, gentlemen, could you take just a minute and tell me what securities activities a big bank holding company can't do today?

Now, I may be wrong about it, but I think the answer is going to be that the only thing you can't do is underwrite or sponsor a mutual fund.

What about it, Mr. Labrecque? What can't a bank holding company do?

Mr. LABRECQUE. The mutual fund question again is a U.S. question. We do run major mutual funds outside the United States.

There are two issues, two answers to your question. One is concerned with the ability to deal in equities, which was a major part of the German example I used a moment ago.

Second, all of the powers that we do have are limited to a relatively modest 10 percent of our business. So we are very constrained in the United States even where we have product capability, and in fact we don't have the ability yet to do equities and quasi-equities.

So, we're missing some products that have been important to us in terms of our business. And, clearly, all of the products we have are subject to significant restrictions vis-a-vis the proportion of that business versus the rest of our business.

Senator SASSER. What do you say about that, Mr. Downey?

Mr. DOWNEY. Well, now, I think that's accurate, that equity issuance, outside of mutual funds, is the only power that is not permitted for the very large banks.

But, again, part of our proposal recognizes that there ought to be other banks besides those who are large enough by size to be able to affect the economies of scale that are necessary to make a section 20 subsidiary work.

So that our proposal would go far beyond that and say there wouldn't be any restrictions for a banking organization to be in securities. So * * *

I would like to, if you wouldn't mind, Senator Sasser, just comment a little on the things that Mr. Labrecque raised on Sumitomo——

Senator SASSER. Sure.

Mr. DOWNEY [continuing]. Because I think that's an interesting thing.

We're kind of proud that our firm is considered a good investment. It represents one-eighth of ownership in our firm and it's a completely passive investment. It's owned by a U.S. bank holding company. Sumitomo owns that bank holding company in America.

Any American bank holding company could make the same kind of investment. So, there's nothing different about the investment that Sumitomo makes in our firm from what any American bank could make.

Now, I can understand the banks not desiring to make passive investments. I imagine that would frustrate them. But, frankly, from the Japanese point of view, it's worked out pretty well. They've got a nice return. They haven't had to put in a lot of management time and talent to understand how the securities business works; they've taken a chance by investing in a securities firm in America, our firm in this case.

And I think we've given them a fairly good return. In the meantime, I think we've increased our own capital to be more powerful as an international competitor.

I also would say that wanting to be in the securities business, you've got to be careful, you know, which securities firm to invest in because, right now, with the Drexel example, and some others, it hasn't been the greatest investment to get into a securities firm.

That may change. I hope it does. We're very much a cyclical industry. But, as for now, it isn't so terrific.

One more comment, Senator.

You know, if universal banking was so good in capital markets, why did Deutschbank have to buy Morgan Grenfeld at 20 times earnings?

That's a pretty darned steep price to pay. I think it shows that the special entrepreneurial qualities of a securities firm are not developed within a universal banking structure.

TOO BIG TO FAIL

Senator SASSER. Well, let me ask this question.

This is something that I think we all three agree on, and that is the so-called too big to fail policy.

As I understand it, both of you think that policy ought to be repudiated, and I agree with that. I think it's obvious that we can't permit wholesale affiliations between federally insured depository institutions and securities firms and maintain the too big to fail policy.

But, let me ask you this question. What if Drexel Burnham had owned a bank? Would the Fed have rescued the entire company?

And I know that, at least in principle, the FDIC only stands behind the bank itself. But, wouldn't there have been an enormous temptation there and a lot of pressure to move in and save the whole structure?

Mr. LABRECQUE. Senator, I would argue that the performance of the Fed and the SEC is very relevant in this situation, because the Fed did have a significant interest here. In this case, it was through the government securities firm.

But I think the record shows they didn't bail them out. The record shows that both the Fed and the SEC stood on the sidelines and were willing to let this thing unwind.

I think, clearly, the banking industry believes in many of the things that have been said here about absolutely insuring the protection of the depositor, but absolutely limiting the exposure of the insurer. We are an institution that has our securities business in a separate subsidiary.

We're not disagreeing at all that there has to be more than reasonable protection for the small depositor and more than reasonable protection from the activities of the securities subsidiary.

The industry has proposed a couple of options. Possibly the strongest is the financial services holding company itself, which has separate subsidiaries functionally regulated.

I think the evidence in Drexel was that the Fed won't jump in. And I think there's more evidence that too big to fail is not a policy that should be maintained and that the system can take it—and did.

Mr. DOWNEY. I don't think, Mr. Labrecque, you quite answered the question on whether, if Drexel were a part of a bank, they would have been allowed to fail.

And I think that's the question. I couldn't agree more that the Fed and the SEC acted properly by letting Drexel fail, and I think that's what our whole system is based on: Where you don't have the Federal funds, and you're not considered too big to fail. Frankly, you aren't too big to fail if you're a securities firm.

And that failure took place. They lived by the junk bond and they died by the junk bond. And we've had an awful lot of other securities firms that have failed and will continue to fail. It still is a risky business.

The question is, at the same time that Drexel was being allowed to fail, the Bank of New England was getting $1.8 billion. I think it was, from the Fed.

Now, I happen to think that's right. I think banks are different and they needed that help and they got it. The question is:

If the Bank of New England and Drexel were one unit—would you have been able to allow Drexel to fail and not allow Bank of New England to fail if they were one organization?

And that I think is a very large question.

Mr. LABRECQUE. I would like to, Senator Sasser, if I might, just——

The CHAIRMAN. Can I just interrupt you there, because we're on the second bells of this vote. And I don't want to shut this down on a key point but I do want us to be mindful of the time.

Can you just make a brief comment before we recess here?

Mr. LABRECQUE. Two points. My position would be that they could let it fail.

No. 2, the Federal Reserve money was a collateralized borrowing, not putting Federal money into Bank of New England.

Frankly, my belief is that, if Drexel had been affiliated with a bank and was under the kind of structure we have in this proposal, that the only thing that should have been protected was the $100,000 deposits of the bank depositors, period.

The CHAIRMAN. With that, we'll recess for approximately 10 minutes and then we'll resume.

[Recess.]

The CHAIRMAN. Let me invite everyone in the room to find a seat and we'll resume.

As you may know, we're coming down the home stretch on the Clear Air legislation today. This has been really a legislative odyssey over the last several weeks, and today is the final day with the vote scheduled tonight.

We're dealing with the last of the amendments this morning and that occasioned the interruption.

Mr. Labrecque, your testimony urges Congress to proceed with financial modernization even if it cannot proceed with deposit insurance reform.

I would like to hear you elaborate about your thinking on that.

Mr. LABRECQUE. Mr. Chairman, it is clearly the belief of the six organizations that I represent that both issues have to be dealt with. But it is also the belief that, clearly, if they cannot be dealt with in a reasonable timeframe, that the world is not going to wait for us in terms of competitiveness.

The positions that will be staked out by our competition domestically and overseas are going to be positions that cannot be overcome.

Therefore, while we would be highly in favor of having deposit insurance and structural reform happen simultaneously, we do not believe it's imperative. If it's going to take a very long time to deal with the deposit insurance question—which we don't think it should but it can—we believe that structural reform must move and move as quickly as possible because the world will not wait for us.

The CHAIRMAN. What kind of ideas do you have to suggest to us on how the insurance system might be changed?

Mr. LABRECQUE. Mr. Chairman, we would go back to the original intent. We would insure only $100,000. We would not have too big to fail. And we would absolutely limit it at that point and make no other change.

Insure the $100,000 deposit, period.

DEPOSIT INSURANCE

The CHAIRMAN. I can appreciate the fact that you hold that view as a position or as an approach that you think might be the best one.

I would have great doubt that the Congress was prepared to go that far, because that would be a major unwinding from where we are today.

And I'm wondering, are there any other ways in which we might approach this deposit insurance issue, that you think we should take a look at, that might not be your preferred answer, but might be one that might be an alternative way to deal with the same problem?

Mr. LABRECQUE. Well, I guess I don't understand what those problems are. I think what we're really trying to do is to secure the savings of the average American. I don't think we're trying to insure the actions of large institutions.

I think we have the methodology to prevent abuses. We have social security numbers, tax identification numbers.

The **Chairman**. Now, let me be sure I understand one thing because I don't want there to be confusion on this.

You're saying that any individual could have one deposit of up to $100,000 insured, or they could have multiple deposits as long as they were different institutions?

Mr. **Labrecque**. In a failed institution, you might only insure up to $100,000 per person. But, that person, as an individual, might have a deposit in the 1st National Bank of Shelby, North Carolina and a deposit in Citibank up to $100,000 and both might be insured.

The **Chairman**. Yes. And so you're envisioning that a person could have multiple units of $100,000 spread across any number of banks or insured deposit institutions?

Is that right?

You're not talking about just one?

Mr. **Labrecque**. Correct.

The **Chairman**. Mr. Downey, do you have any thoughts on this at the moment that you want to share with us?

Mr. **Downey**. Well, that's kind of scary. I think, because that really calls for no change except a hoped for theory that regulators will stop insuring deposits when they get to $100,000. But I don't know of any assurance that that will occur.

Essentially, it seems like the status quo is being advocated. And I think that's terribly dangerous.

What we think is that we have to control how the assets are used. Although in theory only the deposits are federally insured, the law now talks about federally insured banks. That's the way the FDIC statute reads now. We have to be very, very careful about how moneys raised in that fashion are employed.

And we don't think such moneys should be used for securities activities, either domestically or overseas. We don't think that that should be used for——

The **Chairman**. Let me just stop you there because that gets into the broader question of what are allowed or disallowed activities.

You're saying that, in effect, by adhering to the strict letter of the law in terms of deposit insurance, that you don't provide Government protection for any amount beyond the $100,000 limit?

Mr. **Labrecque**. That's correct.

The **Chairman**. And that you would allow depositors to have any number of accounts up to $100,000, as long as they were in different institutions. And that would be your view as to what the change should be in the deposit insurance arrangements.

Is that correct?

Mr. **Labrecque**. That is basically correct, although some limited action may be necessary to avoid abuses by brokered deposits, Senator. But I believe it is quite different than what we have now because the implications of what we have now are that everyone is insured no matter what.

And that institutions are too big to fail.

That's what the current practice is in people's mind.

The facts are that we don't think it should be that way. We think, in other words, this proposal is quite a big departure from the current system.

The **Chairman**. So, in effect, I just want to make sure it's clear not just in my mind, but on the record as well, your thought would be that, if somebody, an individual, had, say, $200,000 on deposit at a given institution and that institution were to fail, the first $100,000 would be covered by the insurance limits.

And then they'd have to stand in line with anybody else, depending on where they were in the pecking order, as to whether or not they got some or all of the second hundred thousand back. Is that it?

Mr. **Labrecque**. That is correct. That is correct.

The **Chairman**. Are you responding with a personal view or a Chase view, or would this be the view of the six organizations that you're representing?

Mr. **Labrecque**. The six organizations clearly agree generally with this view. They have different ideas as to how exactly the subordinated creditors might be paid out.

But, the fact is they clearly support the position I'm talking about that the subordinated creditors, that is, everything in excess of the insured $100,000, would somehow be unwound while the assets on the bank balance sheet are being liquidated.

The **Chairman**. I guess that's another way of saying that, in terms of the Federal guarantee and the risk of the Government and taxpayer to come in and respond to a situation of a collapse in an institution, that you would want to structure the system and the playing field and the regulatory overlay in such a way as to be absolutely certain that you are not going to burn through the $100,000 maximum insurance times all the deposits in the bank.

In other words, that the taxpayer would have a direct interest in making sure that however the system was structured that there was enough protection to not impair that level of capital.

Would that be right?

Mr. **Labrecque**. I think, very clearly, that we are suggesting that there should be enough protection to ensure the safety and soundness of those deposits.

The answer to that is yes.

Very clearly, what we're talking about if we compare it to the S&L situation, and we talked about it earlier in terms of the history of the Hunt Commission, is doing almost the reverse of what we did in that case.

In the S&L case, we clearly didn't do the required restructuring in the 1970's. With this failure to restructure, we were really implying that insurance would cover above $100,000. And then we gave S&L's some powers in the eighties.

What we're saying now is let's limit the insurance. Let's limit it to its original intent. Let's secure the average American. Let's do the restructuring and put discipline back in the system.

And in the process of doing it limit the potential role of the taxpayer.

The **Chairman**. You're convinced, are you, that the $100,000 figure is the right figure?

Mr. **Labrecque**. I am convinced, and I think the institutions that I represent are convinced that it is an appropriate figure. People can always debate whether some historical number is better.

But we think it is an acceptable number, and it's an appropriate number.

The **Chairman**. Yes, I guess I should put that a different way. Is it fair to assume that you would oppose a lowering of the figure?

Mr. **Labrecque**. I personally would. I did not ask all six when I met with them to give me the answer to that. But I believe they would agree with me.

The **Chairman**. Some are suggesting that, as you know.

Mr. **Labrecque**. I don't believe that anyone——

The **Chairman**. I don't say some banks are. I mean——

Mr. **Labrecque**. I don't believe anyone I'm representing did, but I will speak for myself and say that I don't believe we should.

The **Chairman**. Mr. Downey, let me again give you an opportunity to speak. If there are some comments you want to make on that discussion we've just had, why don't you do so now?

If not, I'm going to move on to another item.

Mr. **Downey**. Well, again, we have embodied in law terms such as "insured institution."

And, obviously, that seems to imply something beyond $100,000. If we could succeed in absolutely limiting it to the $100,000, we would have gone a long way.

But I don't think the complete way. Because I think, again, deposit insurance does imply or has implied government backing. And I think there are resolutions by the U.S. Congress to that effect.

And when you have $3 trillion—I think it's something like that—of liabilities that FDIC supports with something like $14 billion of capital funds, and I'm not sure if it's fourteen or eighteen, and I don't know if that's been audited lately—you don't really feel very comfortable from an insurance point of view.

The **Chairman**. Let me ask you, Mr. Labrecque, with respect to the recommendation that the FDIC abandon the too big to fail practice, are there any circumstances that you can envision where a bank should not be permitted to fail?

Mr. **Labrecque**. I, frankly, cannot envision one where the regulators should do anything but let an institution fail. I believe when one looks at our system and what's happened in the last couple of years and the shocks that have been absorbed, I don't think there's any circumstance.

The **Chairman**. And would that also be the view of the six organizations you are representing here today?

Mr. **Labrecque**. Yes.

The **Chairman**. And I take that to mean that that was discussed in that——

Mr. **Labrecque**. Yes, it was.

ACCESS TO THE DISCOUNT WINDOW

The **Chairman**. Well, it's clear enough on that point.

Let me ask this question, Mr. Downey, to you. And that is, with respect to access to the discount window and the payment system for securities firms, why should the Congress extend direct access by securities firms to the payment system in the discount window? Why is this good public policy?

Mr. DOWNEY. Just the terms, first of all. We don't use the term "discount window," because we don't expect that we'll get it at a discount. If we get it at all, it will be completely the Fed's call as to the rate. We would hope it would not be at a harsh penalty rate if we have all the collateral to support it, but we certainly don't expect that it will be at a discount.

With respect to the payment system, we're not talking about the entire payment system. We're talking about the large dollar payments system.

And as we said in our written testimony, perhaps something like that can be constructed in a privatized way with the banks and securities firms and other financial institutions.

So that access to the Fed's payment system may not be as important.

We are requesting access to the lender of last resort, if you will, only in times of generalized liquidity crises. The only time that occurred that comes to mind in my experience would be October 19 and 20, 1987 when there were rumors about our firm, for example, which at the time had the highest excess net capital in the securities industry, maybe not being able to complete a transaction.

You get very concerned in that kind of environment because, although you have plenty of assets and collateral, if you don't have liquidity, you can't do the trade.

And in that circumstance, we would like, in a world where banks will be full competitors in the securities business, to make sure somebody answers the phone at our lending organization in a time of crisis. This would never have affected the Drexel situation. That was something unique to Drexel.

But, in terms of market chaos where, well, let's just say, if Drexel's problems had led to concerns about other securities firms and questions about their liquidity, in that kind of situation, had it become systemic, that is, we think, a reasonable request. It's on the statute books now that the Fed can make such loans; all this would be is a pre-screen.

Again, frankly, if the banks note that the Fed has the power to do that, we don't expect it would ever be used because, with proper collateral, they will answer the phone and make the loan if they know the Fed is going to do it if they don't.

The CHAIRMAN. Now, the SIA proposal that you're putting forward, along with several other proposals that various groups have been floating recently, envisions a new type of financial services holding company.

And I'd like you to tell me which regulator would oversee such companies as you envision it.

Mr. DOWNEY. Well, what we call the Investment Banking Finance Company can be associated with either a securities firm or owned by a bank holding company. Just taking the bank holding company side of that equation for a moment, the bank holding company, if the Congress desires, would still be regulated by the Fed.

And its Investment Banking Finance Company's securities subs would be regulated by the SEC. The securities firm's associated broker dealers would continue to be regulated by the SEC.

If a consumer bank were formed on the securities side, that would be regulated by the FDIC just as the nonbank banks are now, Senator.

The CHAIRMAN. Mr. Labrecque, how do you react to that notion of regulatory overlay and assignment of responsibility in that kind of a structure?

Does that sound about right to you?

Mr. LABRECQUE. Well, there are two things. I have two real concerns about the SIA's specific proposal. One is the question of international competitiveness. I think it goes beyond what will be prudently necessary in pulling things apart.

It fundamentally takes the bank out of the intermediation process. And, certainly, our foreign competitors aren't going to be that way. So I believe it goes too far in that process.

Second, it clearly reopens the nonbank bank loophole without having to pay the costs that are associated with being a bank.

For instance, in the payment system, clearly, we pay for our participation as a bank, including the cost of our reserves and the other costs associated with being a bank.

In our proposal of a financial services holding company or something to that effect, clearly, it is our belief that a securities company like Goldman Sachs could own a bank.

As a matter of fact, today, they do. Prudential today owns an investment bank and two banks that are FDIC insured. We think that structure ought to exist across the board.

Coming specifically to your question of regulation, the way the regulation ought to be is functional regulation, and it ought to be just the way it is done today in the Prudential case. The insurance regulators handle the insurance company, the SEC handles Bache and the FDIC handles, in this case, the two banks.

The CHAIRMAN. Well, you have one immediate anomaly. Just to cite one—there are probably others—we don't exercise the same regulatory control over the insurance business on a national basis that we do these other businesses.

That's done, as you know, at the level of the 50 States.

Mr. DOWNEY. Correct.

The CHAIRMAN. So you would run into that issue as to whether or not you really had a fully connected system. Do either of you feel that if we were to go this route totally and merge commercial banking, investment banking, and the securities business, presumably under some kind of an affiliate relationship, do we need, in addition to functional regulation, some kind of an overall regulatory body that adds up all the pieces to make sure the system as a whole is working properly and is holding together?

Mr. DOWNEY. I do not believe so.

Mr. LABRECQUE. Mr. Chairman, my belief is that we ought to try to do as much as we can with functional regulation.

The pragmatics are probably that there's going to have to be some overall regulation although I think the six groups I represent would probably differ among themselves on the specifics of that point.

I think there's another practical issue. And the practical issue is that we already have a number of institutions in what we would call commerce already heavily involved in various pieces of the financial services industry.

When one talks about an umbrella organization, one's got to talk about how far we want that kind of supervision to get into the making of cars and the making of steam turbines.

So I think the issue is very complex. And I believe as much as possible what you're talking about ought to be tried—functional regulation directed to subsidiaries.

The CHAIRMAN. Well, let me just say to you we've got another vote going on and we're on the second bells here.

I think, if it's the will of the country and the administration, the Congress together to fashion a new system along these general lines and go to a system which ties things together generally along the lines that have been discussed here, and with functional regulation, I would think that—at a minimum through the transition period—you would have to have some kind of an overarching regulatory structure that makes sure that all of the pieces are working together in combination, especially if you've got deposit insurance underneath all of this.

Now you can say that it's only under part of it, but that's one of the questions, as to whether it's only under part of it or not.

But, it seems to me you would have to have some kind of way to take a look at this new amalgamation in the overall.

And I'd like to ask both of you to go back and study that question, if you would. Please consider that question very carefully within your organizations that you're representing. I would think, at a very minimum, you're going to have a transition period where you're moving from today's arrangements, if legislation like this were to be enacted, to the new arrangements.

And I think, to make sure that we get through into a new order of things and that it's solid and that it works and that everything is cross-connected properly and that taxpayers' guarantees and the Government's guarantees are not being put at risk and that we've got a system that works and delivers the financial services the country needs competitively and well-priced and efficiently, I mean, those are all very important questions.

And I think they're questions that we have to be sure are being answered fully so that if we were to embark on this we would not wake up some day and say it was a great idea but, for one reason or another, it didn't work very well.

I think this is one where the engineering has to be carefully enough done and not only designed but carried out so that you really understand how you're going to get from A to B to C and that you've got a very clear sense of confidence that you're accomplishing it.

So I think we've got to have some more thought on that than what I think I hear you saying now.

Yes, Mr. Downey.

Mr. DOWNEY. May I just give you—and I'll try to do it briefly. But that was the central issue or one of the central issues that we considered in coming up with our proposal.

The Proxmire bill and the bills that passed the House Banking and House Energy and Commerce Committees in 1988, constructed firewalls around the separate subsidiary containing the securities activities.

However, we were sympathetic to the bank's point of view of wanting to break down those firewalls so that they could have synergy between commercial banking and investment banking. And that's why we came up with this new plan that takes the federally insured portion of the banking subsidiary of a bank holding company, moves that over separately and keeps that very, very separate.

And that's where we take great issue with Mr. Labrecque's view on firewalls. That federally insured affiliate must be completely insulated and surrounded and not allowed to interact with the free market portion.

And we figure if the rest of it is free market, financed through uninsured deposits, but not having Uncle Sam involved at all, that organization should be, No. 1, allowed to fail—both the securities aspects of it and uninsured banking aspects, and any other aspects, even if there's an industrial aspect of it—and, No. 2, not be regulated at the top.

Whereas, the federally insured part should be completely regulated.

The **Chairman**. Mr. Labrecque, let me give you 15 seconds for any final rejoinder you want to make there, and then I'm going to have to adjourn the hearing at this point.

Go ahead.

Mr. **Labrecque**. There is just a quick remark I would make. I'll repeat what I said before. I think the SIA proposal of making insured deposits that isolated absolutely will make us noncompetitive with everybody else that we're talking about. It is not necessary.

On your question of an umbrella organization, I would say we prefer as much functional regulation as possible. We will provide in writing the rationale for that, and provide it to the committee at some future date.

The **Chairman**. Let me say to both of you this gets right down to the heart of the issue here as to how this might be done if it otherwise makes sense to do. And so I will ask you to give detailed responses, both of you, to that question.

In addition, we are going to have other questions that we're going to ask you to respond to for the record. I know other colleagues feel that way.

The **Chairman**. We have this vote on. I think there's another one coming right beyond it.

So, with that, I'm going to thank you for your testimony today. We'll look forward to your responses in writing.

And the committee stands in recess.

[Whereupon, at 12 noon, the committee adjourned.]

DEPOSIT INSURANCE REFORM AND FINANCIAL MODERNIZATION

WEDNESDAY, APRIL 18, 1990

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The committee met at 10 a.m., in room SD-538 of the Dirksen Senate Office Building, Senator Riegle (chairman of the committee) presiding.

Present: Senators Riegle, Dixon, and D'Amato.

OPENING STATEMENT OF CHAIRMAN RIEGLE

The CHAIRMAN. The committee will come to order. Let me invite our three witnesses to come to the table at this point, and let me welcome you. We're glad to have you with us today. I want to say at the outset that you were very kind to reschedule on short notice because of a conflict we had with our earlier scheduled date.

So, I appreciate your understanding and your willingness to reschedule and be here today.

One of our very esteemed colleagues, Senator Matsunaga, has passed away. A number of our colleagues who otherwise would be here for this hearing are traveling to Hawaii today to the funeral.

So, a number of our members will not be present for that reason, but we will make sure that they will hear what you have to say to us today when they return.

Let me now indicate for the record that this is the second in our series of hearings on financial modernization. We will have over a dozen this year.

During the next few months, the committee will conduct an in depth review of three issues: Financial modernization, deposit insurance reform, and international competitiveness.

Our purpose is to build a foundation for considering specific legislative proposals. The administration may currently be looking at a number of rather sweeping changes and intend to formally propose at some future date.

Our witnesses today represent three prominent consumer and public interest groups—Ms. Sherry Ettleson, who represents Public Citizen; Ms. Peggy Miller, who represents the Consumer Federation of America; and Ms. Jane Uebelhoer, who represents ACORN, which is the Association of Community Organizations for Reform Now.

These witnesses bring an important perspective to these issues, and will make a valuable contribution to our deliberations.

We have asked these witnesses to focus on three issues in particular.

First, how, if at all, should Federal deposit insurance be reformed or changed?

Second, how should the current regulatory structure be changed or improved?

And, finally, should new powers be granted to banks or their affiliates? And, if so, what powers should be granted and with what accompanying safeguards?

These issues affect the health of our financial system and have important implications for the availability and price of consumer credit and investment products.

Consumers have a very large stake in these matters, as both bank and thrift customers, and as participants in our economy and as taxpayers. Our financial institutions must serve the credit and investment needs of our citizens and our economy, but they must not do so at the expense of our taxpayers.

So we must be sure that deposit insurance funds are fully protected as we consider further modernization of our financial services system.

I very much look forward to hearing our witnesses today. I think we'll just start right down the table with Ms. Ettleson.

We would be pleased to hear you. Why don't you pull that microphone right up so you can be heard clearly in the back of the room as well?

STATEMENT OF SHERRY ETTLESON, STAFF ATTORNEY, PUBLIC CITIZEN, WASHINGTON, DC.

Ms. ETTLESON. Thank you, Mr. Chairman, members of the committee. My name is Sherry Ettleson. I am a staff attorney for Public Citizen's Congress Watch. Public Citizen is a nonprofit membership organization representing 50,000 members nationwide. I appreciate the opportunity to testify before you today.

Taxpayers and depositors have a right to demand a commitment from financial institutions to serve basic public purposes. After all, financial institutions could not survive without the stability provided by the many regulatory agencies and insurance funds.

In exchange for this stability, consumers are entitled to a financial industry that serves the public interest. A combination of factors threatens to fundamentally alter the terms of this social compact: deregulation, greed and market forces are pulling banks away from their traditional role and toward more lucrative and riskier investments.

The savings and loan industry's successful push for expanded powers was, in large measure, responsible for the S&L crisis. Now, commercial banks are seeking similar powers. Yet, the banks and thrifts continue to be buffered from the consequences of their actions by the deposit insurance system.

Our banking system privatizes profits and socializes risk. That trade-off seemed agreeable when banks limited that risk and made certain to serve the broad public. Now there needs to be a renewed social contract between those who control capital and those who subsidize it.

Indeed, the structure of the financial system is the key to consumer protection. Consumers and taxpayers have every right to demand that the banking system, part of which they are required to bail out as a price tag of over $300 billion, be made more democratically accountable.

Government supervision of the financial system is at a critical juncture. We are confronted with several crises in addition to the continuing S&L mess: the collapse of the junk bond market failing, northeastern banks, insurance industry insolvency and lack of affordable housing.

Not since the 1930's has there been a greater need for the public to restore safety and soundness and confidence in our financial system. We know that only through vast changes in the relationship between the financial marketplace, government institutions and citizens will there be an adequate response to the gravity of these conditions.

So that the financial system serves the real economy of jobs and production rather than vice versa, citizens must have the opportunity to play a more active role and direct role in both public and private arenas of finance.

Congress has the essential tools to reform and modernize the financial industry. The question is:

What do we build with those tools?

Public Citizen strongly believes that the financial system should reflect national priorities and social values. Any reform of the financial industry should increase democracy, forge a productive real economy and create opportunity for the middle class and the poor.

These goals are achieved by establishing effective, accountable regulation, ending the casino economy and restoring honest business practices.

The most critical and fundamental reform in the banking system is the institutionalization of meaningful citizen participation and policy and regulatory decisions. Today, consumers face the increasingly difficult task of coping with the complex financial market.

Consumer organizations frequently fail to amass the needed resources of expertise to provide necessary information and representation.

Financial consumers associations, or FCA's, would meet this need. FCA's are statewide voluntary organizations established to represent the interest of consumers on financial services issues. The creation of FCA's would better provide information and representation to consumers of financial services, without creating a new government bureaucracy. It does little good to reform the financial industry and instill discipline into the system if the public does not have the opportunity to be an educated and informed participant in the restructuring and oversight of the financial industry.

FCA's, at no expense to the taxpayers, would provide that opportunity.

The second most fundamental issue to establishing effective and accountable regulations is eliminating the banking exemption to the Freedom of Information Act. Only one industry has a blanket exemption from the FOIA, and only one industry's failure has led to a billion dollar taxpayer-funded bailout. Not surprisingly, it is the same industry: financial services.

For more than 20 years, FOIA has enabled citizens to inform themselves about the Government's activities and to participate in public debate. The FOIA creates a public right of access to government information, enforceable in court unless that information falls within a specific exemption.

Incredibly, the financial industry is completely exempt from this important disclosure law. Exemption 8 of FOIA confers a blanket exemption for agencies that supervise or regulate financial institutions. Instead of focusing solely on the security and integrity of financial institutions, exemption 8 operates as a veil between regulators and financial institutions and the public. And the FOIA exemption cuts off entirely the media's access to financial regulatory agency documents.

Section 8 should be repealed or, at the very least, the incredibly broad reach of this exemption should be cut back to include only information pertaining to the solvency and soundness of particular financial institutions.

I would like to briefly highlight another issue and that is reforming the Federal Reserve.

We believe that the most important financial regulatory agency, that is, the Federal Reserve, should be made more accountable to the public. The Federal Reserve is less accountable than all the financial regulatory agencies put together. Moreover, the Federal Reserve controls a fundamental aspect of the entire financial system—interest rates.

Thus, at the very least, the Federal Reserve must be accountable to the public.

Now, I would like to focus on reforms to end the casino economy.

Federally insured financial institutions face a problem of moral hazard. That is, those who make investment decisions bare little responsibility for the consequences of those decisions.

During the last decade, we have witnessed the financial industry embark on a gambling binge with other people's money, all insured by taxpayers. An important reform would include risk-based capital requirements.

Risk-based capital ratios provide a flexible breaking mechanism for the regulators to control credit. They also enable regulators to use their control of loan portfolios to intervene in targeted areas. By assigning different risk ratios to different categories of lending, regulators can indirectly push financial institutions toward certain customers and away from others.

Congress should add a further ingredient to this ratio by lowering capital requirements to meet public purpose needs, such as low-income housing, small entrepreneurs and education.

Financial deregulation deformed the safety net purpose of deposit insurance and turned it into a public catch-basin for risks associated with bad loans, management misconduct and fraud.

Such a casino economy must end.

In addressing the issue of reforming deposit insurance, we believe that the answer to how to reform the system is not to revoke the contract of insuring deposits but, instead, to make sure the financial industry lives up to its side of the bargain.

In our view, the question of whether deposit insurance should be reformed should not be the focus of financial industry reform. Many of the proposals I have heard would create varying degrees of shock throughout the financial system; although some of these suggested reforms are intellectually sound, they serve to remove the spotlight from more important aspects of reform—structural discipline, fiduciary discipline and regulatory discipline are needed far more than market discipline to protect government deposit insurance.

The third prong of reforming the industry is restoring honest business practices to the financial marketplace. Just as laws against bank robbery do not in and of themselves prevent such robberies from occurring, regulatory reform proposals will not serve to protect consumers and the financial system completely from white collar criminals.

Currently, the single most effective tool to combat such pervasive forms of white collar crime is the Racketeer Influence and Corrupt Organizations Act. RICO contains both criminal and civil remedies aimed at punishing and deterring organized criminal activity such as the type of misconduct that set off the multibillion dollar thrift debacle.

Attorney General Thornburgh says that:

"The S&L crisis may turn out to be the biggest white collar crime swindle in the history of our Nation." Lawmakers estimate that due to shortages of staff and resources, the Federal Government has failed to investigate and prosecute over a thousand cases of financial fraud in S&L's and banks.

It would be irresponsible for Congress to eliminate the ability of fraud victims to supplement law enforcement efforts against S&L crooks by watering down the civil RICO. Civil RICO, with its strong remedies, helps to send a message of deterrence while it recoups losses for the Government and individual victims.

We urge this committee to ensure that civil RICO is preserved as an effective tool against sophisticated financial crimes.

In conclusion, I would just like to say that the public is now more than ever concerned and informed about the state of the financial industry.

Mr. Chairman and members of this committee, we strongly urge you to take a leadership role and return this country to a real productive economy and revive the social compact that taxpayers and consumers have with financial institutions.

As necessary partners of the financial industry, the American public must be properly equipped to play a direct role in the system.

Thank you.

[The complete prepared statement of Sherry Ettleson follows:]

PUBLIC CITIZEN

Buyers Up □ Congress Watch □ Critical Mass □ Health Research Group □ Litigation Group

TESTIMONY OF

SHERRY ETTLESON, STAFF ATTORNEY
PUBLIC CITIZEN'S CONGRESS WATCH

ON ISSUES CONCERNING THE NEED TO
MODERNIZE THE REGULATION OF THE FINANCIAL SERVICES

BEFORE

THE COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS
UNITED STATES SENATE

APRIL 4, 1990

Mr. Chairman, members of the committee, my name is Sherry Ettleson. I am a staff attorney for Public Citizen's Congress Watch. Public Citizen is a nonprofit membership organization representing 50,000 members nationwide. Public Citizen represents consumer interests through lobbying, litigation, research and publications. Since its founding by Ralph Nader in 1971, Public Citizen has fought for consumer rights in the marketplace, for safe products, for a healthy environment and workplace, for clean and safe energy sources and for corporate and government accountability.

Taxpayers and depositors have a right to demand a commitment from financial institutions to serve basic public purposes. After all, financial institutions could not survive without the stability provided by federal programs such as the Federal Reserve system, the Federal Deposit Insurance Corporation, the Banking Insurance Fund, the Office of Thrift Supervision (formerly the Federal Savings and Loan Deposit Insurance Corporation), and the Savings Association Insurance Fund. In exchange for this stability, consumers are entitled to a financial industry that serves the public interest.

A combination of factors threatens to fundamentally alter the terms of this social compact. Deregulation, greed and market forces are pulling banks away from their traditional role and toward more lucrative and riskier investments. The savings and loan industry's successful push for expanded investment powers was in large measure responsible for the S&L crisis. Now commercial banks are seeking similar powers. Yet, the banks and thrifts continue to be buffered from the consequences of their actions by the deposit insurance system.

Our banking system privatizes profits and socializes risk. That trade-off seemed agreeable when banks limited that risk and made certain to serve the broad public. Now, there needs to be a renewed social contract between those who control capital and those who subsidize it. In recent years, Congress has enacted some beneficial consumer protections, including requirements for disclosure of credit card interest rates and limitations on the amount of time banks could hold checks (incredibly, the industry is even attempting to roll back these meager protections). But, relative to the effect the financial industry has on our lives, these protections are only short term pacifiers. Indeed, the structure of the financial system is the key to consumer protection.

Consumers and taxpayers have every right to demand that the banking system, part of which they are required to bailout at a price of over $300 billion, be made more democratically accountable.

Government supervision of the financial system is at a critical juncture. We are confronted with several crises in addition to the continuing S&L mess -- the collapse of the junk bond market, failing northeastern banks, fallout from the S&L cleanup, insurance industry insolvency, and lack of affordable housing. Not since the 1930s has there been a greater need for the public to restore safety, soundness, and confidence in our financial system.

If there is a silver lining in the S&L crisis it is that the public is now more than ever, or at least since the Depression, informed and concerned about the state of the financial industry. Citizens are beginning to understand how unemployment, high interest rates, large deficits and homelessness fit together through the financial system. We understand that only through vast changes in the relationship between the financial marketplace, government institutions and citizens will there be an adequate response to the gravity of these conditions. So that the financial system serves the real economy of jobs and production rather than vice-versa, citizens must have the opportunity to play a more active and direct role in both the private and public arenas of finance.

Congress has the essential tools to reform and modernize the financial industry. The question is what do we build with those tools. Public Citizen strongly believes that the financial system should reflect national priorities and social values. Any reform of the financial industry should: increase democracy, forge a productive real economy, and create opportunity for the middle class and poor. These goals are achieved by establishing effective, accountable regulation, ending the casino economy, and restoring honest business practices.

I. EFFECTIVE, ACCOUNTABLE REGULATION

One of the primary causes for the S&L crisis was the industry's domination of the regulatory agencies. Safeguards were removed and the regulators were ineffective. Political influence and conflict of interest pervaded the watchdogs. Senate hearings during the 100th Congress indicated the complete lack of consumer representation and oversight in the financial industry. Had consumers and taxpayers been represented throughout the process, the financial industry would be more accountable and effective and thus, we would not be experiencing a crisis of this magnitude in our economy.

Thus, the most critical and fundamental reforms in the banking system is the institutionalization of meaningful citizen participation in policy and regulatory decisions.

1. Financial Consumers Associations

Today, consumers face the increasingly difficult task of coping with the dizzying and complex financial market. Consumer organizations, stretched to address many issues, frequently fail to amass the needed resources and expertise to provide necessary information and representation. Financial Consumers Associations (FCAs) would meet this need.

FCAs are state-wide voluntary organizations established to represent the interests of consumers on financial services issues. Consumers are notified of the existence of FCAs through a neutrally-worded insert in federally insured depository institution mailings. Once established, the full-time staff of the FCA would represent consumers before legislatures, agencies and the courts, and educate consumers through price surveys and shoppers guides, and public forums. The creation of FCAs would better provide information and representation to consumers of financial services without creating a new government bureaucracy.

This is not by any means a new idea. In 1988, Senator Proxmire held comprehensive hearings on establishing FCAs. The Senate Banking Committee passed a provision in the bank powers bill (S. 1886) to require federally chartered banks to participate if state legislation establishes FCAs. Although it was defeated in the House Banking Committee, an amendment establishing FCAs was introduced by Representatives Charles Schumer (D-NY) and Joseph P. Kennedy III (D-MA) during debate on the savings and loan bailout legislation. Also, four states currently have Citizens Utility Boards, representing over 250,000 consumers, which are similar in operation to FCAs, but monitor utilities instead of the financial services. And, California voters voted favorably for an insurance consumer association contained in Proposition 103.

It does little good to reform the financial industry and instill discipline into the system if the public does not have the opportunity to be an educated and informed participant in the restructuring and oversight of the financial industry. FCAs, at no expense to the taxpayers, would provide that opportunity.

2. Eliminate the banking exemption to the Freedom of Information Act

Only one industry has a blanket exemption from the Freedom of Information Act (FOIA) and only one industry's failure has led to a billion dollar taxpayer-funded bailout. Not surprisingly it is the same industry -- financial services. Certainly, the financial industry has not shown itself to be deserving of an exemption from requirements to disclose government information. Especially since taxpayers insure deposits, they have a compelling interest in protecting against fraud, mismanagement, and agency failure -- and access to information is critical to do the job.

For more than 20 years the Freedom of Information Act has enabled American citizens to inform themselves about the government's activities and to participate more effectively in public debate. The FOIA creates a public right of access to government information, enforceable in court, unless that information falls within a specific exemption.

Incredibly, the financial industry is completely exempt from this important disclosure law. Exemption 8 of the FOIA confers a blanket exemption for agencies that supervise or regulate financial institutions. This exemption allows the withholding from the public any and all information that is "contained in or related to examination, operating or condition reports prepared by, on behalf of or for the use of, an agency responsible for the regulation or supervision of financial institutions." 5 U.S.C. Sec. 552(b)(8). This is an unusually broad exemption for a statute that grants the public broad rights of access to information.

Instead of focusing solely on the security and integrity of financial institutions, exemption 8 operates as a veil between regulators and financial institutions, and the public. As we saw in the S&L crisis, this blanket of secrecy serves to undermine the integrity and security of financial institutions. In addition, the FOIA is one of the media's principal tools with which to oversee the government to ensure it is accountable to the public. The FOIA exemption cuts off entirely a reporter's access to financial regulatory agency documents.

Exemption 8 should be repealed. Or, at the very least, the incredibly broad reach of this exemption should be cut back to include only information pertaining to the solvency and soundness of particular financial institutions. During the debate over the savings and loan bailout legislation, Representative John Conyers (D-MI), Chairman of the House Government Operations Committee, held hearing on amendments to exemption 8.

Chairman Conyers proposed an amendment to insert after "condition reports" the words: "but only insofar as they disclose information concerning the solvency or soundness of a particular institution" and by inserting after "financial institutions" the following: "except for examination reports of federally insured depository institutions that have been liquidated or have received financial assistance from a federal agency responsible for insuring deposits in these institutions." In addition, there was discussion regarding allowing disclosure of examination reports that indicate the performance of a federally insured depository insitution under any statute designed to prevent discriminatory lending practicies. We urge this committee to consider these options

3. Public Representation on Regulatory Boards and Boards of Directors

As insurers of deposits, taxpayers have a compelling interest in decisions and policies that directly relate to how those deposits are used. The interests of taxpayers and depositors must be considered when decisions concerning the direction of the financial industry are made. Therefore, taxpayers should be represented on the boards of directors and regulatory boards that make those decisions.

Taxpayers should have a voice in regulatory policies and should be represented on regulatory boards, such as the National Advisory Board to the RTC Oversight Board. This Board is composed of the chairmen of the six regional advisory boards. Repeating the hazard of industry dominated regulatory agencies that contributed to the S&L crisis, the recently nominated board consists of only current and former bank executives. None are from community groups, housing groups, or even the housing industry -- the people who are greatly affected by the policies and decisions of the RTC.

Taxpayers should not only have a voice in matters concerning regulatory policies, but also in decisions of individual institutions that the government has taken over. Regulators should be required to place people, such as workers, community leaders, or depositors, on the boards of directors of institutions that have been placed in receivership or conservatorship.

More fundamental reform may be called for. We believe that public representatives should be placed on the boards of directors of all financial entities that result from publicly assisted mergers, acquisitions and recapitalization. When taxpayer funds are used to get an institution running again and continue to insure its deposits, taxpayers should be represented in decisions regarding the future of that institution.

We firmly believe that reforming an industry following a devastating crisis calls for bold and drastic measures. Congress must look to the 1990's as a decade for not only a safe, sound, modern financial world, but one that is responsive to the needs of the people and the economy.

4. Federal Reserve Reforms

The most important financial regulatory agency is the Federal Reserve. Yet, the Federal Reserve is less accountable than the FDIC, the OTS, the RTC, the SEC, and the CFTC put together. Moreover, the Federal Reserve controls a fundamental aspect of the entire financial system -- interest rates. Thus, at the very least, the Federal Reserve must be accountable to the public.

A strong democracy requires that citizens have a voice in the decisions that govern their lives and the ability to hold those in power accountable. Former Federal Communication Commission commissioner Nicholas Johnson put it well: "The only way to keep the government upright is to lean on it from all sides." Sufficient information and public awareness are the tools citizens need to effectively "lean" on government.

The Federal Reserve System's (the Fed) control over monetary policy is fundamental to many aspects of people's life, the government, and the economy. Directly or indirectly, the actions of the Fed affect everything from unemployment to the cost of housing and taxes. Yet, it is directed by a group of twelve unelected people. In our democratic society, citizens must be the masters of those decisions. As an agency of the federal government, the Fed should be more accountable to the people, and to Congress, as well as to the Administration.

The Fed can be made more accountable to the public without causing injury to the agency's ability to formulate monetary policy.

The Fed, through the Federal Open Market Committee (FOMC), is an anomaly of American democracy: fundamental economic policy decisions are delegated to a little-known institution that is shrouded in secrecy and shielded from public accountability. It is exempt from the Congressional appropriations process, General Accounting Office audits of its monetary policy, the Freedom of Information Act, and civil service requirements. Furthermore, unlike most other government agencies, the Fed is neither required to publish its decisions in the Federal Register nor to obtain public comment before a decision takes effect.

This is no accident. The Fed is structured to avoid public scrutiny and to give banks and other major financial institutions preferential say in the making of monetary policy. For example, the FOMC, which meets secretly to regulate the flow of capital into the economy, is partly made up of representatives of local federal reserve banks who are elected by private banks. Members of Congress, journalists, and even the president are kept in the dark about the results of these meetings.

The United States Constitution gives Congress the right to "coin money, regulate the value thereof" (Article I, Section 8). Thus, the Fed is entirely under the control of Congress. It is up to Congress to make it more democratic and more accountable.

Defenders of the Fed argue that this insulation from public scrutiny is necessary -- that the politicians who brought about the budget deficit lack the self-control to refrain from overheating the economy, and are leading us down a path of unending inflation. It is argued that this lack of accountability enables the Fed to resist short-term inflationary biases that might be inherent in the democratic process.

This argument fails for two reasons.

First, history would indicate that politicians will not opt for inflation --in 1980 many politicians lost their jobs because of inflation. We should have enough faith in our elected leaders to believe that, given the responsibility, they will of necessity rise to the occasion.

Second, the Fed's tight-fistedness is not a scientific inevitability -- it is a policy choice, albeit one rendered easier by the agency's lack of accountability. Former Fed Chairman William McChesney Martin once said the Fed's job is "taking the punch bowl away just when the party is getting merry." But who would put a prohibitionist in charge of the punch bowl?

The Fed sees as its primary goal the eradication of inflation, which reduces the value of the financial community's main asset, i.e. money -- even if that means a devastating recession. The most notorious recent example was the Fed's shift to monetarism in October 1979, abruptly hiking interest rates over the objections of President Carter and sending the economy into a recession that lasted almost four years. Inflation was broken, but at a terrible human cost. The economists and the bankers at the Fed, rather than elected officials, made the decision that inflation should be fought at the cost of unemployment.

Chairman Greenspan testified before Congress that: "The Federal Reserve must take actions that, while sometimes unpopular in the short run, are in the long-run best interests of the country." Why should decisions concerning the best interests of our democratic country, for the short- or long-term, be made by 12 people in an ivory tower? The issue is who should determine whether or not we have a recession and at what cost: a panel of unelected bankers and businessmen, or elected and accountable representatives of the public.

Important steps toward making the Fed more accountable include: 1) Reducing the term of Governors from 14 to 7 years, 2) Requiring the term of the Chairman to be coterminous with the President, 3) Requiring all members of the Federal Open Market Committee to be nominated by the President and confirmed by the Senate (currently, seven are appointed by the President and confirmed by the Senate and five are appointed by local banking community), 4) Requiring the Treasury Secretary to sit on the Federal Open Market Committee, 5) Requiring the Federal Open Market Committee to make its decisions on a Friday and disclose them on the following Monday, and 6) Including the Federal Reserve's budget in the federal budget process and publishing it as part of the U. S. government budget.

II. ENDING THE CASINO ECONOMY

Federally insured financial institutions face a problem of "moral hazard:" those who make investment decisions bear little responsibility for the consequences of those decisions. During the last decade we have witnessed the financial industry embark on a gambling binge -- with other peoples money, all insured by taxpayers. One segment of the industry failed, and we are faced with an unprecedented taxpayer-funded bailout that will cost well beyond the already appropriated $50 billion. Soon, other segments are due to follow. The S&L bailout legislation took some important steps toward ensuring this crisis would not happen again. However, concerns and problems that reach beyond the S&L industry are in desperate need of attention and reform.

1. Risk-based capital requirements

Twelve industrialized nations, including the United States represented by the Federal Reserve, agreed to impose, starting in 1992, a system of internationally coordinated capital requirements on the largest commercial banks. This agreement, known as the Basle Agreement, will require banks to have capital at a level measured by the type of risk reflected in the bank's loan portfolio. Risk-based capital ratios give regulators an important tool to direct lending to safer and less risky investments. If owners of financial institutions choose to gamble, risk-based capital will require them to gamble with more of their own money. Yet, at the same time, regulators can impose risk assessments in accordance with a public purpose, so that socially-beneficial investments will continue to be made. If twelve nations can agree to these requirements, so should the entire United States financial industry.

Risk-based capital ratios provide a flexible braking mechanism for regulators to control credit by simply raising the institution's lending costs when they see dangers of out of control interest rates. This method would inhibit the Federal Reserve from pushing overall interest rates to extraordinary levels in order to restrict the money supply.

Risk-based capital ratios also enable regulators to use their control over loan portfolios to intervene in targeted areas. For example, if investors were putting a lot of money into agriculture, regulators could reduce credit to agriculture without punishing other interest-rate-sensitive sectors of the economy, such as housing. In addition, by assigning different risk ratios to different categories of lending, regulators can indirectly push financial institutions toward certain customers and away from others.

Congress should add a further ingredient to this ratio by lowering capital requirements to meet public purpose needs such as low income housing, small entrepreneurs, or education. The government is already in the business of allocating credit through the Federal Reserve's control of interest rates and the various federal credit programs. And, regulators control credit allocation indirectly through their choice of whether to intervene on behalf of struggling financial institutions.

Financial deregulation deformed the safety net purpose of deposit insurance and turned it into a public catch basin for the risks associated with bad loans, management misconduct and fraud. One of the clearest lessons of the S&L collapse is that financial institutions should not be allowed to speculate with insured deposits. Financial institutions should be required to demonstrate that they invest publicly insured deposits in a manner that is safe, sound, and for the public good.

2. Tougher accounting rules

The use of Regulatory Accounting Principles (RAP) has been one of the primary mechanisms used by regulators to mask the S&L crisis and postpone the clean up of the industry. RAP allows institutions to value an asset at cost instead of at the price it could sell the asset today. Thus, when the value of an asset decreased, as was the case with junk bonds, the net worth of an institution reported to the regulators was erroneous and undermined the ability of regulators to effectively oversee the safety and soundness of banks and thrifts.

RAP does not disclose a current and honest picture of the value of an institution and thus fails to indicate the extent of exposure of liability to the deposit insurance fund. In the interest of preventing a future crisis and instilling honesty and accuracy in accounting procedures, regulators of the financial industry should be required to apply market-value accounting rules. Under these rules, a federally insured financial institution would be required to value its assets at the value if sold on the open market today. Neither taxpayers, nor the government, should tolerate accounting methods that always paint a rosy picture and fail to disclose the true health of an institution.

3. Early Intervention

When financial institutions begin to slide toward failure, they often are able to obtain forbearance from regulators. Thus, the inevitable is merely prolonged. Also, even when an institution is found to be insolvent, regulatory action may be delayed for over a year. This ultimately leads to extra losses to the insurance fund, and as we experienced in the S&L crisis, increases the costs to taxpayers.

When a bank or a thrift drops below the required capital ratio, the institution should be deemed per se unsafe and unsound. Upon examination and discovery that an federally-insured financial institution does not have the requisite capital, regulators should be authorized to act quickly to appoint a receiver or conservator. Thus enabling the agency to restructure or wind down the affairs of a failing institution before it becomes insolvent.

To prevent excess loses to the insurance fund, an early closure rule should be based on an institution's market value that indicates an institutions is failing but not yet insolvent.

4. Reforming deposit insurance

The social contract created in the 1930's with the establishment of deposit insurance is a core element of our financial system. Consumers put their savings in a federally-insured bank or thrift because they are assured by the government guarantee that their money is safe. This guarantee provides stability to the financial system. In return for the government protections they receive, thrifts and other financial institutions must live up to their public obligations. Under deregulation, these obligations withered while the public exempted financial firms from the normal risks associated with doing business. The answer to how to reform the system is not to revoke the contract, but instead to make sure the financial industry lives up to its side of the bargain.

In our view, the question of whether deposit insurance should be reformed -- should the amount of the deposit covered be lowered?, should the insurance fund be privatized?, should some depositors be asked to take a "hair cut" if the institution fails?, should the insurance policy be limited to one per customer? -- should not be the focus of financial industry reform. If the amount of the insured deposit is lowered, those who have more than the covered amount will just rearrange their accounts to match the insured amount (on average, consumers have less than $10,000 deposited; thus this measure would not directly effect the majority of depositors). Privatizing the insurance fund may adversely impact the availability of credit to community development and small business. Further, depositors should not be asked to risk a percentage of their deposit when they are not given any information about the type of risk they are taking by depositing their money in one institution over another.

Depositors must receive accurate and meaningful information on the safety and soundness of the depository institution before they are asked to have a "hair cut."

All of these proposals would create varying degrees of shock throughout the financial system, causing a destablizing jolt to the economy. This is not something that we can afford at this delicate moment in our economy.

Although some of these suggested reforms are intellectually sound (especially, perhaps, limiting insurance coverage to one per customer) they serve to remove the spotlight from more important aspects of reform. Brokered deposits, which in large measure, fueled this debate, already have been restricted by the bailout legislation. Structural discipline, fiduciary discipline, and regulatory discipline are needed far more than market discipline to protect the government deposit insurance funds.

5. Expanded Powers

In the wake of the 1929 stock market crash and subsequent bank panic, lawmakers limited the ability of banks to make risky investments. The 1933 Glass-Steagall Act prohibited commercial banks from investing in the stock market, in return for the new system of federal deposit insurance. The rationale was simple: taxpayers ought not subsidize speculation.

In recent years, however, big banks have mounted an intense drive to repeal Glass-Steagall and win expanded powers. A new breed of aggressive banks is eager to reap better return through investments in the stock market and real estate and through selling insurance. Early in 1989, the Federal Reserve unilaterally granted the biggest banks new securities powers.

When coupled with strong safeguards, some expanded powers may be beneficial (such as insurance powers), and some are at least neutral in impact (such as municipal revenue bonds for small jurisdictions).

But expanded securities powers threaten the integrity of the banking system. First, banks would risk economic instability by plunging into risky securities investments. Second, allowing banks to underwrite securities raises potential conflicts of interest. This is so even when banking and securities activities take place in separate subsidiaries, because walls separating such entities are notoriously porous. Finally, letting banks buy securities firms would augur a spasm of economic concentration unlike any before in American history.

Furthermore, the debate should not begin to focus on expanded powers until banks and thrifts provide basic banking services to all consumers. Banking services are essential in today's world. However, sixteen million Americans do not even have a relationship with a bank. People who do not have a relationship with a bank face an extra hurdle in getting credit. Federally insured deposit institutions should be required to offer and market low cost bank accounts so that all citizens can have access to affordable banking services.

7. Prohibit federally insured depository institutions from selling uninsured debt paper

Twenty-three thousand people, many of whom are elderly retirees, unsuspectingly invested their savings in junk bonds sold through offices of Lincoln Savings and Loan, a California thrift that has been taken over by the government. According to the bondholders, employees of Lincoln informed these customers that the bonds in which they were investing were as safe as their insured deposits. Many of these people lost their entire life savings in now worthless bonds. And, this practice has not been limited to Lincoln Savings and Loan. Other thrifts are currently authorized to sell uninsured stocks and bonds in their retail branches.

Because of the great imbalance in access to information and financial sophistication, bank and thrift customers are at a great disadvantage in making investment decisions. Customers must, and easily can, be protected from financial institutions that take of this imbalance.

Retail branches of federally insured banks and S&Ls should be prohibited from selling any debt or stock in an affiliate of the bank or thrift. And, regulators should have explicit authority to act to protect depositors and customers if the regulators determine that any uninsured product being offered by the institution could be confused for an insured deposit.

Depositors and consumers must be fully and accurately informed about the instruments in which their money is being invested. Only then can consumers protect themselves from bad investments decisions. Representatives Charles Schumer (D-NY) and Tom McMillen (D-MD) have introduced legislation to address this problem. This Committee should do the same. —

III. RESTORING HONEST BUSINESS PRACTICES

In a recent op-ed in The New York Times, Stephen P. Pizzo wrote: "Thrift deregulation, and the money it made so easily available, triggered a catastrophic collapse of ethics at every level of business, sweeping Government into its grasp." Just as laws against bank robbery do not in and of themselves prevent such robberies from occurring, the aforementioned reform proposals will not serve to protect consumers or the financial system completely from white collar criminals. The law must have teeth and must be adequately enforced to protect the public from criminals in the financial system.

1. Increase officer and director liability

Recently, FDIC Chairman William Seidman testified before Congress that 60% of the S&L failures were due in part to insider fraud and abuse. A 1988 study by the Comptroller of the Currency revealed that of 171 national banks that failed during 1979-1987, insider abuse was a significant contributing factor in 35% of the failures.

Instilling discipline in bank management is an essential element in reforming the financial industry. The scope of liability for misconduct by officers and directors must be expanded.

To close the accountability gap, senior officials and directors of federally-insured depository institutions should be held strictly liable for misconduct that leads to institution failure. "Misconduct" should be defined as fraud, negligence, or self-dealing. In addition, when an institution fails, uninsured depositors and individual shareholders should have standing to sue the bank officials, and should be allowed to recover treble damages.

The only private remedy currently available, derivative stockholder suits, is cumbersome and often ineffective. And, for a variety of reasons, regulators often fail to pursue available civil and criminal remedies.

2. Immediate disclosure of denial of receiverships

The cost of cleaning up Lincoln Savings and Loan in California is estimated to be $2.5 billion. The taxpayer bill increased exponentially due, in part, to the delay in closing it down. Had Lincoln been closed down when regulators in San Francisco recommended, part of the billion dollar loss could have been prevented. But, instead, the examiners' recommendation was overruled by the Federal Home Loan Bank Board and Lincoln was allowed to continue conducting business for another two years.

To safeguard against similar incidents, Congress may want to consider requiring the immediate disclosure in the Federal Register of financial regulatory agency's decision to overrule a regional office's recommendation. Disclosure would include an explanation of the reason for overruling the determination. This requirement could cover decisions concerning the safety and soundness of an institution including whether it should be taken into receivership, whether it should be completely closed down and taken into conservatorship, and whether an institution should be investigated further for misconduct.

3. Racketeer-Influenced and Corrupt Organizations Act

FDIC Chairman William Seidman estimates that 60 percent of the failures in the S&L industry were caused by criminal fraud. In order to punish the wrongdoers, deter future criminals, and recoup as many losses as possible from the fraudsters who profited at the taxpayers' expense, the law must contain strong remedies and it must be enforced. Currently, the single most effective tool to combat such pervasive forms of white-collar crime is the Racketeer-Influenced and Corrupt Organizations Act (RICO). RICO contains both criminal and civil remedies aimed at punishing and deterring organized criminal activity, such as the type of misconduct that set off the multi-billion dollar thrift debacle.

Under RICO's civil provisions, victims of "patterns" of criminal activity -- including mail, wire and bank fraud -- may sue the criminals for three times their losses plus attorney's fees. Triple damage liability often provides the only effective means for victims, including government agencies, to be compensated for their injuries; at the same time, it provides a potent deterrent to future wrongdoing. That is why both the RTC and the Lincoln bondholders have brought civil RICO lawsuits against Charles Keating and his associates for their alleged activities that brought about the single largest S&L failure to date. And the FDIC predicts that it will bring more civil RICO suits in its efforts to clean up the thrift industry.

Legislation is pending in the House (H.R. 1046) and the Senate (S. 438) that would eviscerate civil RICO's effectiveness against bank fraud and other white-collar crimes. The bill would eliminate triple damages in most civil RICO cases, thereby diluting the law's ability to deter wrongdoing and compensate victims.

Attorney General Richard Thornburgh says that the S&L crisis "may turn out to be the biggest white-collar crime swindle in the history of our nation." Lawmakers estimate that, due to shortages of staff and resources, the federal government has failed to investigate and prosecute over 1,000 cases of financial fraud in S&Ls and banks. It would be irresponsible, at the very least, for Congress to eliminate the ability of fraud victims to supplement law enforcement efforts against S&L crooks by watering down civil RICO.

In order to prevent future widescale looting of financial institutions, it must be made clear to the potential thieves that, if they are caught, they will be punished harshly. Civil RICO, with its strong remedies, helps to send this message of deterrence while it recoups losses for the government and individual victims. We urge this committee to ensure that civil RICO is preserved as an effective tool against sophisticated financial crimes.

4. The role of accountants in the financial crisis

Last year, the General Accounting Office reported that in six of 11 failed thrifts it studied, accountants "did not properly audit and/or report the savings and loans' financial or internal control problems in accordance with professional standards." Currently, most of the six big accounting firms are prohibited from doing business with the RTC because they are being sued by the agency for impropriety in their S&L audits.

Congress should, at the very least, take the lead to determine the extent fraud and conflicts of interest by accountants contributed to the crisis, and enact reforms to prevent similar occurrences in other aspects of the financial system.

CONCLUSION

Speaking at a conference in St. Louis in December on Democratic Money, William Greider, author of Secrets of the Temple, asked:

> "... what do you [ordinary citizens] bring to the discussion of money and credit that the experts often don't? Each of us has our own sort of native values, common sense, what we learned from the Bible as children, what we learned from our mothers about what's right and wrong. Those are all economic ideas, though the way economics is organized they are excluded. However, if you bring what you already know about the subject of finance, it will lead you to the conclusion that this system is not only not functioning in our interest, but it really offends our deepest values in profound and continuing ways."

The public is now more than ever before concerned and about the state of the financial industry. Mr. Chairman, and members of this committee, we strongly urge you to take a leadership role and return this country to a real productive economy and revive the social compact the taxpayers and consumers have with financial institutions. As necessary partners of the financial industry, the American public must be properly equipped to play a direct role in the system.

The **Chairman**. Thank you. I will make your full statement a part of the record. There were various items that you did not mention in the interest of time. But they will all be included in the record.

And I will go back and ask some questions a little later.

Ms. Miller, we would be pleased to hear from you now.

STATEMENT OF PEGGY MILLER, LEGISLATIVE REPRESENTATIVE, CONSUMER FEDERATION OF AMERICA, WASHINGTON, DC

Ms. **Miller**. Thank you. I'll summarize my remarks.

My name is Peggy Miller. I'm here representing the Consumer Federation of America. The last time I was before you, Mr. Chairman, it was 1 year ago, before we started to mark up the S&L bill. And, in a way, it's a pleasure to be here again today.

But, I wanted to start off, before moving in a sense into deposit insurance, on what we see as the evolving situation for now and for the next year with just a few very clear points that we feel very strongly about in terms of the current situation regarding RTC and the OTS system that we mandated within the FIRREA law.

Since we passed the bill last year, we have been working very long hours with RTC and with OTS and with FHFB on all the regulations, et cetera.

Because of that, we have become somewhat well-acquainted with the situation down there. In my opinion, it is not doing them or the asset disposition situation at the current time any good for a number of Members and Senators to be talking about merging.

The reason I feel that is——

The **Chairman**. When you say "merging"?

Ms. **Miller**. OTS with OCC, FDIC with NCUSIF, everyone. The rumors that are flying, the bills that are out. These rumors and bills are having an impact in terms of asset distribution and disposition. When you passed FIRREA, which strengthened bank regulation, we all knew this was the year that was going to be difficult. The pressure was going to come this year, when the thrifts were being closed down, when they were having to sell the assets.

In my opinion, to immediately move to discussing changes and weakening amendments as soon as the pressure becomes difficult is very poor action. I'm not pointing the finger at any one particular person, but this is not in any way helpful.

The clear message that most buyers, and that even the bureaucrats are getting that have to deal with this, is they don't know next year what's going to be up, whose making the decisions, so it's generally in no way helpful.

To further underscore, there were many things in that bill that were very useful. We supported it in terms of the developments with FHFB and with the thrift system because we felt that we'd crafted something that was worth supporting.

Because of that, we need the boards in place and we need basically to move forward with that, not to move backward. They do need help. They need more staff. In my opinion, the shuffling of staff that has occurred, that's already happened, all right, let's work with them.

But they need far more staff and far more equipment and far more capability in order to keep up with the system.

But, from there, where do we go from this point?

The **Chairman**. You've made some important points—ones that I've made myself here. I think the package needs to stay in tact, and time to work.

Obviously, the team has to be on the field. There's been some very considerable delay in getting the full team on the field. We just got the two public service members of the RTC oversight board through our confirmation hearings. They were sent up only about 3 weeks ago.

Ms. **Miller**. Yes.

The **Chairman**. And they're now moving on an expedited basis. Leaving aside the uncertainty about reorganization for the moment. Is it your view that the essential elements of the package are sound? Does this still look like a good, solid road map to clean up the problems, if implemented properly?

Ms. **Miller**. In my opinion, it's very close to what we thought it was. I think everyone was aware it was not the total cleanup needed.

For example, we wanted desperately to have additional pieces, such as early intervention and even stronger capital standards. In my opinion, those items are still needed.

There should be an analysis of additional tools to bolster what you've put in place.

Is it a good first step? Yes. They have the tools to work with. It's been more of a problem looking back to the Congress, as they always do, to see are they going to really have the support to enforce this, you know. Once the pressure starts, are they going to be pulled off of what was basically put in statute?

That's why I'm concerned at the present time.

The **Chairman**. I'll come back to that.

We have been joined by two of my colleagues. I interrupted you right at the front of your statement. But, you've made a very important point and I want to discuss it with you before we go any further.

Ms. **Miller**. Do I still have time?

The **Chairman**. Absolutely. If I may, as long as I've interrupted, I think I might call on each of my colleagues to make their initial comments. We will preserve all your time. There's no rush.

Senator **Dixon**. Mr. Chairman, I have a statement I've already placed in the record, so I won't take any of the time of the committee now.

I'm glad to see these witnesses here. I will defend to the death Ms. Miller's opportunity to use all her time. I'm anxious to hear from her and to talk about deposit insurance.

The **Chairman**. Senator D'Amato.

Senator **D'Amato**. Mr. Chairman, let me commend you for calling these hearings and taking the time from your busy schedule to chair them.

I am simply going to ask that my statement be included in the record as if read in its entirety.

The **Chairman**. We'll make them both a part of the record.

OPENING STATEMENT OF SENATOR DIXON

Senator DIXON. Mr. Chairman, I am pleased to be here this morning as the Senate Banking Committee holds the second in a series of hearings on modernizing the financial services industry. I look forward to the testimony of your assembled witnesses, each of whom has met with me in my office in my capacity as chairman of the Subcommittee on Consumer and Regulatory Affairs and each of whose organizations has testified before the same subcommittee.

Mr. Chairman, I commend you for scheduling this hearing. Although I disagree with these consumers' opposition to expanded asset powers for banks, I value the participation of consumer groups in this important debate.

Although my conclusion on certain modernization issues may differ, I do agree with two goals outlined by testimony from today's witnesses. I agree that we must make sure that taxpayers are protected against risks from the Federal Deposit Insurance System. I also agree that our financial services industry has an obligation to help meet the needs of communities and individual consumers.

I do not believe that either of these goals is inconsistent with expanded powers for banking organizations. When we get beyond the myths and the false analogies, I believe that the facts support my position.

OPENING STATEMENT OF SENATOR D'AMATO

Senator D'AMATO. Mr. Chairman, I commend you for the patience you have demonstrated by scheduling this series of hearings on financial modernization. As you know there have been many false starts in the race toward an effective and fair means of sorting out the myriad difficult issues associated with the reform of our banking laws. In past Congresses various interest groups have engaged in an unproductive conflict under the assumption that this was a zero-sum contest for a finite financial services market in which they were the only player. It is now clear that this assumption has been overtaken by events.

I am pleased that the chairman has placed so much emphasis in this Congress on the global nature of the financial services industry of the 1990's. Clearly improving competitiveness and consumer benefit in every segment of America's financial services industry should be the focus of our effort toward financial modernization legislation.

And today's hearing has a symbolic as well as a practical purpose. As previous testimony on deposit insurance has pointed out, the degree to which the Government supports the profits of the banking industry must be commensurate to the genuine public purpose that the banking system serves. One of the reasons I am so enthusiastic about the Cranston-D'Amato-Garn comprehensive banking bill is that it will promote competition for the business of consumers of bank products and services. After all, Mr. Chairman, competition is the most reliable means we have discovered to date for promoting low-cost consumer benefits.

So I look forward to the testimony of our witnesses and hope that they have some constructive suggestions for deciding these difficult issues of taxpayer safety and competitive efficiency.

The CHAIRMAN. Ms. Miller, do you want to continue?

Ms. MILLER. Yes. I was going to shift from that point to—obviously, it's all inter-related—the next stage, where now, in addition to the problems at hand of asset disposition and enforcement of FIRREA, we are now encountering troubling statistics regarding the current standing of the BIF fund, worries about what's happening with the New England banks and what solvency position that commercial banks are in.

That overall question, on the BIF fund, and worries and concerns over the solvency of our bank structure as well, has put the issue of deposit insurance reform on the table.

We agree with it being on the table. We have been trying to review the various statistics that have been presented to the committees over the last 6 months. And also try to move into a position from our standpoint on deposit insurance reform.

The first point that I want to make is on deposit insurance itself.

We emphatically feel we need a system. I make that point because some people are questioning whether deposit insurance in and of itself is a useful tool any more. We feel that it is.

But, we also feel that there are many things that need to be done in order to make it serve the purpose for which it was created. Some of the ideas being put forth before the committee we feel need investigation, because they raise various points in terms of deposit insurance.

But we feel that none of them deal with the problem in totality: such as what has been called the haircut approach, where you would pay for future insolvencies or additional insolvencies by lopping payments off the top of uninsured depositors accounts—5 percent, 15 percent, et cetera.

Our concern there is reality. History has shown that the very largest depositors tend to avoid such payments. We are very concerned that, in effect, only a certain percentage of depositors would actually be impacted by that.

Cutting down to $40,000 as the insured level is another approach being suggested. Our concern is the same there. What are the impacts on the smaller banks in terms of deposits? Can it be implemented correctly because of the capability of the system to manipulate the overall structure so they can basically get around it?

So, dealing from a reality standpoint, what that brought us to was looking at the whole picture—what's evolved over the last 10 years—since we moved into deregulation?

Simultaneously with deregulation has evolved the high-speed technology system we have today. Because of that evolution, what you have is a system where the U.S. taxpayer, in essence, is backing the entire financial structure. For example, when the Federal Reserve did move into the Continental-Illinois Bank to protect depositors from a run, when we did move into 1st Republic, and the NCNB structure we covered all deposits, uninsured and insured, foreign and United States. All of those examples, plus the current combination of offshore deposits, offshore banks, foreign deposits in our banks and the overall positioning of the Fed to support the dollar's value at almost any cost, and the cost has been in the billions, describe a concentrated structure having little connection to deposit insurance.

The taxpayer, in essence, is backing the entire system. One can argue whether or not that is a good idea. In fact, I think that this structure, in and of itself, should be analyzed because this has evolved so rapidly.

I don't think everyone expected this to evolve. I don't think when the deregulation laws were passed over the 1980's that anyone really was able to analyze and understand the impact of the combination of computer equipment as well as deregulation to realize the extent this would go to uncontrollable global concentration.

But, it has gone to that extent. So, in our opinion, you have two ways that you can go in this situation.

You either can assume that it's already evolved and analyze what you need in order to control it and regulate it for the public interest. Or you can try to re-regulate it, curtailing its size, concentration, and ability to operate so quickly.

In order to control it, you have to have systems which match the complexity of the system that you have allowed to evolve. That means your staff, the regulator's staff and their very systems have to be able to counter the complexity of the hourly, minute-wise decisions capable of this sophisticated structure.

Is that possible?

We question if it's possible. But, in the line of making suggestions along that level, we have submitted in our testimony that there is a potential for using newly defined risk-based capital standards and tools of that nature by the Central bank and connected to economic development planning to encourage asset disposition that might, if they were computerized and moved up to the regulator's top level, be capable of somehow staying equal to the level of what you've allowed to evolve.

I want to stress that point very clearly because, in our opinion, when you removed interstate banking restrictions and when you allowed the level of large deposit movement, broker deposits, all of those things, what has evolved is you have removed in a sense your low level management structure.

Your bank manager and your small bank used to make the decisions on the local and regional level in terms of risk. They were a part of the process. They factored in economic development and community development as a part of risk.

Because of the secondary market system, which has now institutionalized much of your loan arrangements, and because there is no more interstate banking restriction, you have people making lending and investment decisions that go into areas where they have no concept of what the economic impact is. My point here is that, in my opinion, your risk definition is no longer complete enough; because you've allowed an international system to evolve of this nature, you need a risk definition that equals the risk impact of those types of loans, meaning:

Because your risk definitions and your capital-based standards are being set by international levels, then you have to somehow have the flexibility within those so that the money is still steered into your local economies.

I notice Japan has decided to move an ever increasing amount into manufacturing and into product development. In essence, what I support is that that decision on their standpoint bolsters their local economy. That keeps their economy strong, so they can then purchase the assets and they then do not experience the economic impacts that we currently—because we're not funneling money into manufacturing, we're not funneling money into the product area—are experiencing because we're not bolstering our local economies, and we are relying on international investors to steer our economy.

There aren't enough high-paid jobs resulting from our service economy. And so, when you have to dispose of the assets, you've now currently arrived at the problem, such as RTC assets. They don't sell.

Why don't they sell? We don't have enough people to buy them. It's all interlinked. And all I'm suggesting is you've got to develop a more sophisticated tool system in terms of what you have to operate with, or you have to go back to a system that's less sophisticated so that you can control it.

But, one way or the other, you've got to achieve control. And in our opinion right now, we don't have it.

That is one of the reasons why I make my final point—should we move into securities at this point and insurance powers?

Our concern over that overall situation is, if you move into securities at the moment, the money center banks, et cetera, they are at a 3-percent tangible capital—not even tangible—risk-based capital situation.

If they move into securities at this time, when you have no controls and your regulators have no controls of where the impact of that money will be put, in my opinion, you will continue to exacerbate the problem.

So we would encourage that you look into a more sophisticated approach of control, so that the money can be funneled back into our economy and thereby you might be able to maintain control of the system.

Thank you.

[The complete prepared statement of Peggy Miller follows:]

Consumer Federation of America

TESTIMONY BY PEGGY MILLER, CONSUMER FEDERATION OF AMERICA
BEFORE THE SENATE BANKING COMMITTEE

April 4, 1990

MODERNIZATION OF FINANCIAL SERVICES REGULATION

1424 16th Street, N.W., Suite 604 • Washington, D.C. 20036 • (202) 387-6121

Mr. Chairman, Members of the Committee, I will endeavor today to briefly discuss Consumer Federation of America's (CFA) concerns regarding the financial system's regulatory structure. I will focus on the need for reform of deposit insurance within the context of the overall regulatory structure, and the granting of new powers within the context of how reforms must help address overall consumer needs for safety and soundness as well as access to affordable credit and services.

We are faced with the dilemma of having created an enormously concentrated and interwoven financial structure which reaches into every part of our economy and into the economies of most nations and which links financially insured investments with those that are, strictly speaking, uninsured.

Financial concentration of this magnitude and complexity -- without the constraints of equally complex, broad and tough regulations operating within well defined economic development and public policy guidelines that can respond with similar speed -- could decimate our entire economic system as well as the savings of the people across this country.

It already threatens to do so. We are faced with a financial system controlled by lenders and financial risk takers from countries across the world. The U.S. taxpayer as well as the unfavored businesses are picking up the tab for the necessary bank and thrift closings, and for real interest rate controls exercised by the Federal Reserve, resulting from poor lending decisions.

Some 600 thrifts have gone under, and many banks as well. Assets are for sale everywhere, and real estate values are under question. More banks are expected to face insolvency shortly. Large deposits can be pulled at a moment's notice, sending a ripple of panic through the system.

I liken this fiscal situation to Three-Mile Island.

The federal deposit insurance system and the structure of our central bank system, our branch-banking system and our thrifts were established to provide depositors with a safe haven for their funds. This system was also intended to provide more order within the flow of money, thereby assisting commerce and communities to flourish in a steadier, more controlled financial framework. Currently, those goals are being seriously threatened.

We ask the Committee to consider the following methods as means to update the current regulatory system so it can achieve such goals once again:

** Provide for the effective, complete analysis of the current financial system by outside parties operating in the public interest through the provision of complete data. Current debates over the status of the Bank Insurance Fund (BIF) related to rumors of widespread insolvencies within New England banks and the northeast in general are made more difficult since parties outside the agencies are unable to obtain complete information in order to make proper and thorough determinations;

**Bolster tangible capital standards over the next decade, setting a goal of 6%, to achieve a strong cushion for protection of the insurance fund.

**Increase flexibility and use of risk-based capital standards by individual regulatory agencies and the Federal Reserve for the purpose of strengthening banks' capital cushion and for the direction of long-term lending within a broader risk definition. This risk definition should relate to economic development performance in local and regional areas to achieve overall national economic goals for stronger manufacturing/product development, stronger business development, new inventions, and community development, including housing. (This offers a possible substitute for interest rate control of the economy.)

**Connect the use of risk-based capital standards for lending direction with the RTC's need to find buyers through an overall economic development approach that guides more lending away from those areas which promote concentration and do not provide better paid jobs, and towards diverse methods of business and job stimulation in many communities.

**Strengthen regulators' capability for control through early intervention provisions that allow regulators to move into a supervisory or enforcement position before insolvency occurs.

**Analyze impacts of and methodologies for placing limits on the size of banks and/or the powers of big banks. This is needed because of the "too big to fail" and firewall failure problems and because of the impacts of such problems among institutions of great size on the insurance fund, on consumers in general, and on the overall financial system and economy.

**Restrain any moves to allow for broader institutional powers within the current framework, where banks and thrifts are faced with extremely difficult management concerns due to the fragile, shifting economy and incorporation of new regulatory standards.

**Refrain from unnecessary, time consuming, delay-frought shifts or merges in the current management structures of any agencies. Instead, provide RTC, OTS, OCC and FDIC with support for current enforcement procedures and standards, capital to continue operations, and additional staff to handle closures effectively and efficiently.

**Move accounting procedures to market value methods.

**Keep the credit union insurance system separate from the FDIC system.

Deregulation policies in the early 1980's assisted in speeding up the financial concentration and meshing process. Also contributing was the development of information and communication systems that allow increased international concentration of funds, development and broad use of brokered deposits, and swift, vast money transfers at any hint of fiscal concern within a given institution across all borders.

As a result of such highly computerized fiscal concentration, combined with the allowance of the Federal Reserve to serve as the bolster of our overall economy, our deposit insurance system, for all intents and purposes, really insures our entire financial system, including foreign deposits, large corporate deposits, the economic status of many large corporations and the debt of many countries.

We are no longer just insuring deposits up to $100,000. In actuality, we are insuring all deposits. This shift to a "too big to fail" policy was evidenced in the First Republic and Continental Illinois cases. Using infusion of funds and innovative takeover schemes costing the public billions of dollars, the central banking system moved in to ensure that these enormous banks would not be allowed to fail, including all uninsured deposits. This situation also is evident in the use of the Federal Reserve's discount window and in the decisions in cases such as NCNB.

This concentration alone is dangerous, since even the best honed regulatory apparatus would have difficulty in controlling high speed fiscal decisions around the globe to prevent such decisions from seriously impacting the U.S. economy, the safety of the insurance fund, or the level of services offered to the consumers in this country.

It is even more troubling due to the lack of such regulations, the lack of highly qualified regulators, and the lack of creative, new regulatory tools that can have any expectation of matching the complexity and speed of the current international financial system with equally, or even nearly equal, triggers for fiscal control. It is also troubling because there is no direction to the madness: no economic direction and no restraints on financial flows that threaten our economic stability and drain our communities.

FEDERAL DEPOSIT INSURANCE REFORM:

Depositors have not caused the current crisis, and should not be made to bear the weight of the solution. Depositors need a safe banking system. Where mistakes have been made, where concentration has been allowed to grow to unacceptable levels, where additional regulations are needed to control risk-taking or poor management, where lending has been allowed in areas proven to hurt our economy or our communities, let us resolve such problems with the regulations and the controls needed, and not simply turn to depositors for bailout costs when the system falls apart.

Federal deposit insurance provides a mechanism to cover the safety of deposits. It should not be abolished. The moral hazards caused by the current "riskless" environment of the big banks come from the lack of regulation, lack of enforcement, and lack of authority within our financial system to match the complexity of our newly developed monetary system.

Though I applaud the American Bankers Association for endeavoring to come to grips with the "too big to fail" problem. Their proposed "hair cut" solution, paying for future big bank insolvencies by trimming a percentage off the top of uninsured deposits, does not address the problems within the system that lead to its instability, its riskiness, and the continued need for costly bailouts.

In fact, the "bailout from uninsured depositors" approach, though a more equitable payment system than the current combination of taxes and bank fees paid by all depositors, would probably only lead to a skewed payment system in the face of necessary bailouts. Very large depositors seem to find ways to avoid payments, since they are the most powerful entities within a bank system. Other uninsured depositors -- such as the elderly who have amassed personal investments over $100,000, but may have forgotten to or may not have thought to divide up their fortune into separate accounts -- will take the hit.

For purposes of protecting the insurance fund, we must recognize that the problems will continue and grow until we address the current financial structure with the tools needed to provide proper control. This must occur within a context of a public policy which addresses the broader impact of our financial structure on our overall economy and way of life and which provides our regulators with the policies and means to manipulate this system for the good of all, not just for the good of a few, as we are witnessing now.

To accomplish this we need to enforce the standards passed in FIRREA, and broaden such standards on a continuing basis over the next few years, while looking to develop more flexible tools and provide more guidance for our regulators.

Though concepts such as a lowering of the overall deposit insurance cap to $40,000 seem on the surface to take a worthwhile approach to achieving overall lending restraint, such a restraint does not address the ease with which our wizard financial experts could manipulate such caps, currently evidenced by the brokered deposit approach. A cap would need to apply per household, and then some mechanism would need to be established to ensure that all deposits meet these restrictions.

Even so, such caps would never apply to large depositors and corporate desposits, and thus the system would still be susceptible to the threat of instantaneous withdrawal of such large funds and to the risks related to the manipulation of such funds.

Therefore, to protect the federal deposit insurance fund, we recommend the following approaches:

I) UNDERSTAND THE PROBLEM:

The extent of the problem in the BIF fund continues to be a topic of debate due to the broadly differing views among many who have testified on the impacts of real estate holding and LDC debt on northeast and southeast areas as well as on many banks throughout the system. It has been pointed out that statistics are not available to those outside the system who are endeavoring to analyze the potential problem. CFA asks that this Committee move immediately to ensure that such statistics are publicly available so that we all have the best information at our disposal.

II) PROVIDE A STABLE ADMINISTRATIVE ENVIRONMENT WITH CLEAR AUTHORITY:

A) RTC/Oversight Board:

Though CFA did not support the establishment of a separate RTC system for the sale of assets, viewing such an establishment as unnecessary and costly, this agency is now established. Separation of the Oversight Board and RTC complicates the overall system.

We do recommend a possible merging of the Oversight Board with the RTC board as a way to eliminate unnecessary decision-making processes. We do not recommend the simple elimination of the Oversight Board, since the representation on that Board of Mr. Greenspan and Mr. Kemp provides input we see as worthwhile in overall planning.

Furthermore, to move away from the current RTC/Oversight structure through total elimination at this time wastes precious time. The shift itself would cause delay and confusion and underscore lack of direction. Furthermore, such a move only sidesteps the problems that will continue:

** need for more, trained staff and operating capital;

** need to incorporate a national economic/employment/product development framework into the overall asset disposition system, which should be coordinated with other departments and agencies to achieve more diverse, stronger local economies that will, in turn, lead to an improved climate for asset disposition; and

** the need to employ a more full blown planning and marketing system for the assets in hand.

B) OTS/OCC/FHFB merger:

Current suggestions for streamlining by merging OTS and OCC, and thus probably FHFB, are not assisting those in either agency to deal with the problems at hand. It is not surprising that it is difficult to find a bank regulation expert to run OTS at this time. Why take a job which may not exist within a year? There is no clear-cut authority to operate, therefore the capacity to do the job is severely limited. Those in command need to be provided with necessary authority and provided with support to carry out the laws as drafted last year.

If the objective of streamlining is to cut costs, and eliminate unnecessary jobs due to the diminishing size of the thrift industry, then such streamlining can occur within that industry and its regulating agency.

More importantly, from the consumers position, a merging of OTS and FHFB with OCC may contribute to even greater financial concentration in a direction which has been of no real use to consumers.

The reason that CFA supported the continuation of a thrift system within the type of mandates placed within the FIRREA legislation was for the purpose of developing a financial network which had the role of serving consumers through the basic, fiscally conservative tenets of providing consumer and community mortgage, business, and community lending, as well as affordable banking services.

Since the banking system had been moving away from such lending pursuits so dramatically, as evidenced by the enormous growth in real estate development, commercial paper, junk bonds, LBO and LDC debt, CFA worked with others to define a part of the system to fill the enormous market nitch for consumer and community lending and services.

OTS and FHFB, if supported in their overall ability to direct and administrate the FIRREA laws, and allowed to perform their tasks as laid out, with a few changes where streamling and conflicting goals between programs exist, might have a chance of doing just that.

CFA recognizes that many commercial banks have been moving aggressively into the mortgage lending field. For this reason and because of other management difficulties associated with the differences between such banks and the money center and multi-regional banks, CFA is analyzing the impacts of combining the management of such institutions together, possibly under the wing of OTS and FHFB, while shifting the management of all money-center and "big" banks to FDIC or the FED. Corresponding deposit insurance programs related to size and type of lending could be built into such a system. This approach is only one option, in our opinion, for grappling with management problems. Limitations on overall bank size could be a more positive way to deal with problems.

C) FHFB Board positions:

The FHFB board must be filled with full time positions immediately. There was never any intention for the Secretary of HUD to be forced into the time consuming position of running the FHFB. And though we did intend to eliminate the leverage of the Federal Home Loan Bank System of the past over the newly created Federal Housing Finance Board, we did not intend to shift the entire leverage over to the Department of Housing and Urban Development. A board which includes a consumer representative and five full time members must be moved into full action immediately.

D) NCUSIF

Merging the NCUSIF (the national credit unions share insurance fund) into the FDIC system is a concept we do not support. Credit unions are completely different units of finance, with a community and membership base, as well as a non-profit status. They have historically taken care of themselves and have done a reasonable job of meeting this requirement. Merging this system into the FDIC system, which is experiencing great difficulties at the current time due to northeast insolvencies, would place great strain on both funds and serves no purpose.

III) STRENGTHEN REGULATORY POLICIES:

The above changes will be useless and possibly fatal for our deposit insurance system, unless combined with reform of the overall system that assures regulators of the capacity to enforce fiscal soundness and to deal more creatively with the impacts of monetary regulation on our economy.

Therefore, in addition to holding to the current basic FIRREA laws for the time being, with the inclusion of a merger of the Oversight Board and RTC Board, the provision of more working capital to RTC, and the ability to hire top staff from the outside wherever needed, we need to make additional changes, changes that continue along the path of FIRREA by:

** strengthening current tangible capital standards, working toward a goal of 6% tangible within ten years;

** streamlining and broadening the capacity of risk-based capital standards to be used for reduction of moral hazard as well as to provide the central bank with lending controls which could be used in place of, or in addition to, real interest rates for economic controls (such use of risk weightings would require the use of longer, broader term as well as short, narrow term definitions of overall economic risk);

** training of regulators in detection of risky lending patterns along both short and long term paths;

** strengthening the hands of the regulators by providing them clear, strong early intervention policies which allow intervention before technical insolvency exists, improved technical capabilities, as well as far greater overall numbers of skilled supervisors and examiners; and

** use of market value accounting methods.

But that is not all. On a level of equal and greater importance:

** We must address the realities and economic impacts of this evolved financial concentration by establishing clear public policy frameworks to assist our financial banking and securities regulators in their use of these tools, as well as the others they already have at hand, so that financial lending and borrowing decisions support our national economy by contributing to manufacturing, employment related businesses, housing needs, education, invention, infrastructure and other consumer credit needs.

** We must not accept the current concentration as a given, since its very size and interwoven nature threaten the core of our system. We need to consider and analyze various possible alternatives such as:

-- limiting the size of any given financial institution so that it's solvency status alone can no longer threaten the complete system, thereby tackling the "too big to fail" problem through limiting size; and

-- placing constraints on the immediacy with which withdrawals of a certain large size from insured institutions are allowed to occur, thereby slowing down, at least by hours, the swift impacts of major shifts in large deposits and possibly reducing the fragile nature of the current climate.

IV) BANK POWERS--

In the current financial and regulatory climate, a move to broaden bank powers at this time is entirely inappropriate. It has become clear that regulators do not agree with this position, since there have been continued moves by the Federal Reserve and by the OCC to allow the sales of insurance and securities.

Recently, OCC proposed broad new authority for national banks and federally chartered savings associations to sponsor and manage common trust funds. The OCC proposes to permit banks and thrifts to offer a range of services previously not granted under the laws pertinent to the handling of common trust funds. The use of such services and the loosening of the restrictions surrounding common trust funds are designed to stimulate investment in these funds. Such investments will not be insured, but the confusion surrounding such investments may lead to misinterpretation by consumers and investors, and thus a threat to a new set of deposits.

Banks are being granted new powers to sell, and in some states, to underwrite insurance. Little attention is being given to the fact that solvency questions are a growing concern within the insurance industry, and thus strong links to this industry, particularly in the underwriting area, could be risky.

Regulators and bank managers are having a difficult time implementing current regulations, and we have not yet seen a great capacity to carry out even these mandates. To allow further product development and sales through the banking system when their capacity to handle such diversity seems so tenuous is shortsighted and places additional strains on a system that is not performing well.

It is true that sales of additional products, such as insurance or forms of securities, can enhance the revenues of banks and thrifts. But this approach led to the loosening of restrictions in the early 1980's, which, when uncoupled from strong regulations and safeguards, brought on current costs and instability.

Current regulatory safeguards are not yet strong enough and are not yet in place. Regulators are swamped with their responsibilities at the moment, and will have difficulties overseeing new ones.

Furthermore, CFA has concerns about the capacity of the banking system to safeguard the interests of the consumer in the provision of securities, and even in the provision of insurance products.

CFA has performed studies on the selling of life insurance by savings banks. These studies showed a strong competitive link to the sales of life insurance by banks through a marked reduction in cost to the consumer compared to the prices quoted for the same product from insurance companies and independent agents.

We found such facts of importance, and as a result have supported the rights of states to allow banks to sell insurance in their state, due to the lesser risk associated with the sale of life insurance products. Still, we have continued to warn of the problems related to the selling of insurance by banks, problems of proper disclosure and tying, which must be addressed properly. An additional concern, particularly in the light of growing concerns about insurance insolvencies, would be that any such changes are made within the context of protection for the consumer so that competition does not leave companies insolvent overnight and consumers without savings.

In the area of securities the issue becomes more complex. The issues of risk to the system, confusion of the consumer, difficulty of providing proper firewalls between the banks and its affiliates as shown in the Continental Illinois case (where the bank moved large sums into its commodity trading subsidiary in the wake of the 1987 crash), as well as the speed with which such products are bought and sold, render the situation very difficult to regulate.

Safety and soundness concerns related to securities are far stronger as is the potential for misleading situations related to the sales of insured versus uninsured products to the consumer.

Finally, CFA is analyzing the relationships between the continued development of securities and the use of the secondary market in regard to the safety and soundness of the system overall, particularly in relationship to the reduction of the role of the banker as primary creditor and overseer. The reduction in this role as pooling and packaging arrangements have become commonplace has shifted virtually the entire problem of oversight of loans to the regulator. Regulators have no direct ability to judge individuals or to work with individuals on their loan situations. Therefore, we have given up a very critical component of the banking system.

CFA has previously emphasized the need for bank branches to provide services, but this additional relationship between the need for bank attention to the loan product as it relates to overall safety should be further explored.

I would encourage this Committee to deal with the overall framework at hand, its needs for integrated, flexible, controlled approaches to the current safety, soundness and management problems being experienced by our regulators.

The **Chairman**. Thank you very much. We'll make your full statement a part of the record.

Now, Ms. Uebelhoer, we'd like to hear from you.

STATEMENT OF JANE UEBELHOER, LEGISLATIVE DIRECTOR, [ACORN] ASSOCIATION OF COMMUNITY ORGANIZATIONS FOR REFORM NOW, WASHINGTON, DC

Ms. **Uebelhoer**. Thank you, Mr. Chairman, members of the committee. ACORN appreciates the opportunity to testify before you this morning.

First, I would like to note that ACORN agrees with and endorses most, but not all, of the suggestions made here by my colleagues from Congress Watch and the Consumer Federation.

ACORN calls upon the committee to adopt two principles to guide their reforms of the regulation of the Nation's financial industry in terms of deposit insurance, regulatory restructuring and your consideration of expanded powers for banks.

The first principle we urge you to endorse is to take great care to protect low- and moderate-income people from being harmed by these changes.

Second, whatever legislation the committee passes should be used as a vehicle to promote the sorts of public values that have been discussed by Ms. Ettleson and Ms. Miller this morning.

We sincerely hope that you'll keep these principles in mind on a daily basis. Let me elaborate.

First, protect low- and moderate-income people. It goes without saying that minor changes in financial institutions can telescope into major impacts on people's lives. We must anticipate and prevent fallout.

Two illustrations. First, risk-based capital ratios will soon be imposed on financial institutions by regulators to steer banks away from certain kinds of lending that appear dangerous. This will reduce bank profits on junk bond, take-over deals and other risky lending.

We commend strategies to improve safety and soundness in the system and protect the insurance funds. But, recently improved regulations implementing the risk-based capital ratio concept will be a disaster for poor people unless Congress intervenes immediately.

In general, these regulations give single-family mortgages high-risk weights, 50 percent, even though mortgage lending is safe business, and we know that from experience.

But, mortgage loans with high loan to ratio values will be given extremely high-risk—100 percent. In fact, a bank must put as much capital risk behind a 90-percent LTV loan as behind a delinquent loan. This is an insult to working people and it reflects a shallow comprehension of the realities of home financing.

Home loans to low-income people with counseling have a lower default ratio than the average mortgage loan in an institution's portfolios. Much worse, this arrangement will mean that ACORN members and their neighbors will no longer be able to purchase homes.

This outright government red-lining will be the end of low-income homeownership in Detroit, in Chicago, in New York and elsewhere.

A second example. We have always and continue to oppose expanded powers for banks. Our reasons are simple. Most banks have not come close to living up to their current legal responsibilities to serve low and moderate-income people. The situation will only get worse if banks move into new fields.

Banks will become boutiques for up-scale clientele. More branches will slam shut in low-income neighborhoods. Essential deposit and credit services will become more expensive and less accessible. The people that bankers are already neglecting will receive even less attention and, frankly, in the wake of the thrift industry collapse, it seems incomprehensible that serious consideration is being given to permitting banks to get involved in new risky undertakings, firewalls notwithstanding.

As a seasoned observer recently noted:

If you give expanded powers to banks, you won't need to hire regulators any more. We will just need to get morticians.

The second principle that I wanted to articulate and hope that you keep before you in your deliberations is that we should use legislation and regulation which reforms banking systems to promote public values.

The S&L crisis is a dramatic example of what America is willing to do for her banks, but what are her banks willing to do for America?

ACORN believes that economic justice goes hand in hand with economic prosperity. A healthy, well-housed, decently educated and productively employed citizenry is necessary to a stable and productive economy. No discussion of this country's economic well-being should be silent on this point.

Congress has a wealth of opportunities to promote social justice as it alters the banking system. To mention two, and these are just sketchy, but I think important examples:

First, we propose a flexible mechanism to regulate interest rates, to eliminate the wild fluctuations which crush people on the bottom of the economic order and make people at the top conservative and sometimes small-minded.

Second, we recommend that the deposit insurance system be used to channel investment where we all agree it needs to go to revitalize communities and create jobs.

For example, one proposal is to moderate the price an institution will pay to insure funds which are related to investments which are sound, safe and productive. And which fit the framework of public values and national priorities of employment and housing.

The price of deposit insurance would be higher for funds put into investments that are unsafe, unsound, speculative and which thwart national goals.

Another approach to reform deposit insurance is to limit the option of qualifying for insurance to public purpose lenders. This would create a segmented industry with a subindustry of community finance institutions that would preserve the values of widespread ownership and local intermediation. Only special purpose banks, thrifts and credit unions.

For example, I include community development credit unions and community development banks would offer insured deposits.

To conclude these brief remarks, I would like to note that I bring before the committee today an open letter to Congress on proposals to revise the banking system. A version of this was appended to my written testimony, which we submitted a couple of weeks ago. This is a newer version. It has not changed in substance; it has changed stylistically.

We will be circulating this far and wide throughout the land to get the signatures of hundreds of institutions and organizations, civic leaders, churches, labor unions, in support of this letter and will bring it back to you within a few months. But I wanted to introduce this formally at these hearings today.

Thank you, Chairman Riegle, and members of the committee, for the opportunity to speak today. We look forward to working closely with the committee as these reform efforts develop and are articulated.

[The complete prepared statement and an open letter to Congress of Jane Uebelhoer follows:]

Testimony presented to

Committee on Banking, Housing and Urban Affairs
U.S. Senate
Senator Donald Riegle, Chairman

on
Legislation to Modernize the Regulation of Financial Services

by

ACORN
Association of Community Organizations for Reform Now
Jane Uebelhoer, Legislative Director

April 4, 1990

ACORN appreciates the opportunity to present testimony before the Senate Banking Committee on legislation to modernize the regulation of financial services. We are glad that the Senate has decided to draw on ACORN's views and experience in shaping policy on this important topic.

To provide a framework in which to better understand our analysis and suggestions, we will begin by explaining who we are and what we do.

ACORN

●ACORN, the Association of Community Organization for Reform Now, is the country's largest organization of low and moderate income people. Founded in Arkansas in 1970 by a group of welfare mothers, ACORN has grown to include hundreds of neighborhood groups in 40 cities in 27 states.

●ACORN is a multi-issue, multi-racial organization. ACORN's purpose is to bring people together to fight for social justice. Every day, ACORN members work through neighborhood groups to win improvements in our local communities, and also come together through citywide and national campaigns to tackle larger, common problems. ACORN members address a range of issues including expanding and preserving the stock of affordable housing; providing jobs for the long-term unemployed and removing barriers to voter registration. We also work on problems related to bank services, education, utility rates, health care, safety and police protection, toxic waste, drug abuse prevention, child care, and more.

●ACORN groups are first organized at the neighborhood level to work for community improvements. Each neighborhood group is represented on a citywide board. As a national organization, ACORN is governed by an Association Board, composed of two delegates elected from each state. The Association Board is responsible for the overall direction of ACORN, for national campaigns and policy decisions.

●Since 1985 ACORN has been fighting for access to banking services. Using the Community Reinvestment Act (CRA), ACORN groups around the country have gotten banks to commit to invest more than one-half billion dollars in low income neighborhoods. These agreements contain many other significant provisions, including commitments to develop and market affordable checking and savings accounts; use alternative creditworthiness standards in evaluating loan applications; count sweat equity as part of the downpayment on a property; provide and pay for loan counseling and packaging; and put branch offices in our neighborhoods.

•ACORN's national banking campaign grows out of the dozens of ongoing local banking projects. ACORN helped fight for and win the permanent authorization and expansion of the Home Mortgage Disclosure Act; we were highly involved in a near-successful attempt to add community protections and benefits to the last bank powers bill; and ACORN was a lead voice in the 1988-89 S&L bailout debate and legislative process. We work with bank regulatory agencies in Washington and in the field -- most recently to make sure that the CRA, HMDA, housing, and housing finance provisions of FIRREA yield benefits for low income people.

Broad Principles for Financial Restructuring

We should all take a lesson from the collapse of the thrift industry -- different lessons, to be sure, depending on our roles. From what ACORN leaders around the country are reporting, the lesson of the S&L debacle is just now beginning to sink in for poor people: **make sure that politicians close the barn doors now regardless of where they think the horses are.**

To be poor means to suffer severe hardships and limitations due to lack of economic resources. What is it to be poor and to realize that an estimated $300 billion will be spent on the S&L mess? To feel bitter and angry, at least, that such a vast public fortune is being utterly wasted merely because laws were not properly enforced. Think of the good that could have been done with that money! (or how much better off we'd be not to have spent it at all.) Poor people want to be relieved of poverty, not simply sustained in poverty with government programs. But in the meantime, what about government programs? $300 billion would otherwise be able to (choose one):

*Finance rehabilitation of the 10 to 12 million currently abandoned or dilapidated houses.
*Finance, at current levels, federal prenatal care programs for 1,434 years.
*Pay for the clean up of 3,000 of the worst toxic waste sites.
*Run the Drug Enforcement Administration for 524 years.
*Finance the US Food for Peace Program at its current level for 272 years.

One principle ACORN urges upon Congress is, therefore: **Reduce the level of taxpayer liability for failures in the financial industry.**

Second, **public protections demand public obligations.** Clearly, deposit insurance is only part of the larger system of taxpayer guarantees to the financial system which include, for example, the Pension Benefit Guaranty Fund, state guaranty funds for life/health and property/casualty insurers, and the various government sponsored enterprises.

And though the government safety net covers only part of the industry in a statutory sense, it covers the entire universe of financial actors in a practical sense -- pension funds, insurance companies, money market funds, commodities traders as well as banks and securities firms. The fates and the business operations of all of these industry segments are already bound up together as financial services become more and more integrated.

Deposit Insurance: Proposal One

What obligations could be fairly and sensibly imposed on institutions in exchange for insurance? One proposal is to moderate the price an institution would pay to insure funds dedicated to investments which are safe, sound, productive and which fit the framework of public values and national priorities, like employment and housing. The price of deposit insurance would be higher for funds put into investments that are unsafe, unsound, speculative and thwart national goals.

Deposit Insurance: Proposal Two

Another approach to reform of deposit insurance is to limit the option of qualifying for insurance to public purpose lenders. This would create a segmented industry with a sub-industry of community finance institutions that would preserve the values of widespread ownership and local intermediation. Only special purpose banks, thrifts and credit unions (current examples include community development credit unions and community development banks) would offer insured deposits.

Two further refinements should be added to the proposal that deposit insurance only be made available to public purpose lenders. (1) Interest rates paid on insured deposits should be regulated and (2) Institutions eligible for deposit insurance should treat ordinary credit requirements as being equally important as the protection of depositors and the stability of financial institutions.

(1) It is crucial to remember how deposit insurance blew up in our faces. It was not just because the ceiling was mysteriously raised to $100,000 and not only because of the "too big to fail" doctrine. It happened because the ceiling was more than doubled at the same time that interest rates were

decontrolled.

A 1986 report from the Telecommunications and Finance Subcommittee of the House Energy and Commerce Committee, "Restructuring Financial Markets," calls interest rate deregulation "a dramatic example of the way that current ad hoc, piecemeal process of financial restructuring has led to the consequences that threaten the stability of both the financial system and the economy. While certainly unintended, the decision to permit depository institutions to pay market rates of interest on short-term insured financial assets constitutes a unique experiment in the history of this or any other financial system" (p.9)

There are several ways to implement controls on interest rates that are considerably more flexible than Reg Q and that recognize and respond to the global nature of monetary policy. It is perfectly feasible to identify national investment priorities (like affordable housing and cutting-edge manufacturing) and design a special purpose lending industry to service those priorities at low interest rates flexibly pegged to intelligent benchmarks, like the discount rate, or the Fed funds rate, or ups and downs in the larger economy.

(2) The system has privileged depositors at the expense of ordinary borrowers. Virtually all of the trends in the industry, from interstate banking to FIRREA, have made it more difficult for low and moderate income people, nonprofit enterprises, small businesses and family farms to borrow money. The system of publicly chartered and insured banks is intended to do more than safeguard depositors -- the system must also make loans to ordinary people and small institutions. Of course people should have access to a risk-free avenue for saving, but we must attend as well to the responsibility to make funds available to all creditworthy borrowers.

If only public purpose banks qualified for deposit insurance it would be especially important to mandate that these institutions reach out to ensure that credit flows where it is needed.

Regulatory Reform

We urge that state and federal regulation of insured institutions be coordinated, and that regulation be toughened up overall. (ACORN does not currently take a position on the question of whether the Office of Thrift Supervision should be merged with the Office of the Comptroller of the Currency.)

Expanded Powers

ACORN has testified before Congressional committees on several occasions on the questions of whether banks should be permitted to move into new types of business. We have always, and continue to, oppose expanded powers for banks. Our reasons are simple but, nonetheless, compelling. Most banks have not come close to living up to their current legal responsibilities to serve low and moderate income people. This situation will only get worse if banks move into new fields; banks will become boutiques for upscale clientele. The people that bankers are already neglecting will receive even less attention.

Since April 1987 the Federal Reserve Board has been approving applications submitted by bank holding companies to allow wholly owned nonbank subsidiaries to underwrite and deal in certain securities. In March 1990 GAO reported that it is too early to predict the implications of these activities. "...the scope of the bank ineligible activities has been limited thus far, as the subsidiaries continue to organize their operations, develop the products and services they plan to offer, and identify the markets they will enter. Accordingly, it is too early to draw conclusions about Section 20 firms' impact on the market, their profitability, their riskiness, or the adequacy of the regulatory system in which they operate." (GAO/GGD-90-48 Bank Powers, p. 4)

Frankly, in the wake the the thrift industry collapse, it seems incomprehensible that serious consideration is being given to permitting banks to get involved in new risky undertakings, firewalls notwithstanding. If ever there was a time to be careful, it is now.

In sum, ACORN will be working to:

- promote innovative, comprehensive deposit insurance reform,
- demand tough enforcement of bank laws and regulations, and
- oppose expansion of bank powers.

[Attached to this testimony is a Joint Statement on Deposit Insurance Reform and Restructuring of the Financial System drafted by the Center for Community Change. This statement is being circulated to community, consumer, and civil rights groups, labor unions, civic leaders and churches throughout the country for signature. It will be presented to Members of this Committee and others at the completion of the signature process.]

JOINT STATEMENT TO CONGRESS ON DEPOSIT INSURANCE REFORM AND RESTRUCTURING OF THE FINANCIAL SYSTEM

Americans are increasingly concerned about the stability of our financial system. The S&L crisis and its aftershocks have heightened public awareness about the adequacy of the regulatory process and the manner in which important public policies regarding banks and other financial decisions are decided.

Congress will shortly be asked to consider a number of ways to restructure the banking system. Among these changes are proposals to reform the deposit insurance system, presumably aimed at retaining the benefits while limiting the government's exposure to loss. The banking lobby is also pressing hard for congressional permission to engage in new business activities, such as mutual money market funds and selling and the underwriting of insurance. Any of these changes will have profound effects on the banking system and the way in which financial services are delivered to the public.

Whatever the eventual approach restructuring takes, its proponents will undoubtedly tout it to the public as being pro-consumer. However, the experience with financial deregulation must lead us to scrutinize very carefully the potential impacts of any "reforms" that are proposed.

The reality behind deregulatory intitiatives, such as the phase out of interest rate ceilings on deposits and interstate banking suggests that not all consumers and neighborhoods will fare equally from financial restructuring. In fact, some segments of our population may actually be harmed by these changes.

For example, advocates of interest rate decontrol maintained that it would benefit consumers by promoting competition and improve the way banking services are provided to the general public. But, as we have seen, small savers and low and moderate income consumers have often been the net losers from the switch to market rate deposit accounts. Whatever increased yields they have received on deposits have been more than offset by fee hikes most banks have imposed on their accounts. Meanwhile, others have been priced out of the banking system all together.

Similarly, the public benefits generated by interstate banking are uncertain, at best. The 1985 Supreme Court decision allowing interstate banking compacts between the states, set off a merger and acquisition frenzy, resulting in increasingly larger regional, superegional, and national banking giants. Much of this activity has merely resulted in weakening the links between local communities and their banks, which was once viewed as the cornerstone of the U.S. banking system. We have yet to see any tangible benefits produced from interstate which serve the needs of the average family.

In short, we are deeply frustrated by the way in which banking policy has been set. Too many of our legislators seem preoccupied with enacting measures intended to increase bank profits or protecting the turf of some segment or the other of the financial services industry. Clearly, we need banking policy that concentrates on the broader public interests -- increasing the flow of investable capital to needy segmants of our economy, and providing Americans with a place to save their hard earned wages and to transact their financial business. Unfortunately, our present system too often has ignored the needs of of certain population groups, especially low and moderate income consumers, urban neighborhoods, small and minority owned businesses, and the small farmer.

It is important to recognize the stability that deposit insurance has brought to the financial system since its inception in the 1930s. Changing this system will set off a wholesale restructuring of the banking industry. Accordingly, this decision should not be considered on narrow grounds, but must encompass the broader questions of who will benefit and who be harmed by the restructuring that will follow changes to the deposit insurance system.

Likewise, expanding bank powers to engage in new fields will have important ramifications for how well these institutions continue to perform their traditional banking activities. It is insufficient to simply label certain new powers as "pro-consumer" and therefore determine bank entry into a new area reflects the broader public interest. Congress should consider the impacts of these changes on the ability of banks to serve community credit needs and provide traditional services to their customers.

It seems that as banks continue to move along the deregulation route, their focus has shifted so dramatically to high profit margin products that the average and low income consumers are simply being forgotten. We believe that financial reform must start with fashioning a system that works for the vast majority of Americans and not only the interests of a comparative few. We look to Congress to help ensure that the earlier experiences with deregulation of financial services is not merely repeated again. In considering future financial reform, Congress will balance the interest of the banking industry will consumer and neighborhood needs for protected access to financial services.

OPEN LETTER TO CONGRESS ON PROPOSALS TO REVISE THE BANKING SYSTEM

Americans are becoming increasingly concerned about the stability of our financial system and the way in which it functions. The S&L crisis and its aftershocks have raised suspicions about the adequacy of the regulatory process and how vital public policies decisions are made regarding banks and other financial institutions.

Congress will shortly be asked to consider ways to restructure the banking system. Among these changes are proposals to revise the deposit insurance system, presumably aimed at retaining the benefits while limiting the federal government's exposure to loss. The banking lobby is also pressing hard for congressional permission to engage in new business activities, such as offering money market mutual funds and selling and the underwriting of insurance. Any of these changes will have far reaching effects on the banking system and the way in which financial services are delivered to the public.

Whatever the eventual approach restructuring takes, its proponents will undoubtedly hail it as being pro-consumer. However, the experience with earlier financial deregulation suggests that proposals for restructuring the banking system must be scrutinzied very carefully to determine their potential impacts on various segments of our economy.

The reality behind the previous generation of deregulatory initiatives, such as the phase out of interest rate ceilings on deposits and interstate banking, demonstrates that not all consumer and communities will fare equally from financial "reform." In fact, some sectors of our population may be harmed by these changes.

For example, advocates of interest rate decontrol maintained that it would benefit consumers by promoting increased competition and improving the way banking services are provided to consumers. But, as we have seen, small savers and modest income families appear to have become net losers from the switch to market rate savings accounts. Whatever increased yields they have received on their deposits have been more than offset by fee hikes most banks have imposed on their accounts. Meanwhile, many lower income families have been priced out of the banking system all together.

Similarly, the public benefits generated by interstate banking are uncertain, at best. The 1985 Supreme Court decision allowing interstate banking compacts between the states set off a merger and acquisition frenzy, resulting in increasingly larger regional, superegional, and national banking giants. Much of this activity has merely resulted in weakening the links between local communities and their banks, which was once viewed as the basic cornerstone of the US banking system. We have yet to see any tangible benefits produced from interstate banking, at least as far as the average family is concerned.

In short, we are deeply frustrated by the way in which banking policy has been set by Washington. Too many of our legislators seem preoccupied with enacting measures intended to increase bank profits or protect the turf of some segment or the other of the financial services industry. Clearly, we need a banking policy that concentrates on broader public concerns -- increasing the flow of investable capital to the needy segments of our economy, providing families with a safe place to keep their hard earned wages and a widely available method for transacting their financial business. Unfortunately, the current system all too often ignores the needs of many Americans, especially those with low and moderate incomes, or those who reside in older urban neighborhoods. Small and minority owned businesses and the small farmer are being disadvantaged by the trends in banking as well.

It is important to recognize the stability that deposit insurance has brought to the financial system since its inception in the 1930s. Tampering with this system is likely to set off a wholesale restructuring of the banking system. Accordingly, the decision to modify the current deposit insurance system must not be considered too narrowly. Judgments about the need to revise the deposit insurance system should encompass a broad range of public policy considerations, one which fairly and accurately assesses the likely beneficiaries and victims of such policy changes.

Likewise, expanding bank powers to engage in new fields has important implications for the overall stability of the financial system. However, Congress must also question whether these changes will adversely effect the ability of banks to serve community credit needs and provide traditional financial services.

In recent years, the focus of banks has shifted so dramatically to offering high profit margin products that the needs of many consumers and communities seem all but forgotten. We believe that the starting point for future financial reform must be on fashioning a system that works for the vast majority of Americans and not only the interests of a comparative few. We look to Congress to help ensure that the previous experience with financial deregulation is not repeated. In considering future restructuring measures, be they changes to the deposit insurance system or expanded powers, Congress must do a better job of balancing banking industry interests against the far broader need for protected access to financial services for consumers and communities.

The **Chairman**. Thank you, very much.

I have asked the staff to look at the data on the one point you raised that I wanted to pin down. That is, the question whether the risk of waiting on home mortgages was tilted in such a way as to make mortgage credit less available, say, compared to other things that might have even a higher risk profile, or do not represent community values or public values.

The information I have indicates that the Basel Accord will set up an international standard of 8 percent capital for commercial loans, commercial real estate, multifamily projects and consumer loans.

Under the international standard home mortgages would require 4 percent capital. One might argue that that is figured too high, but it is only half of the other.

For mortgage-backed securities which consist of broad portfolios of home mortgages rolled together, the capital standard is 1.8 percent. But that is a concern to me, as well. Going to a risk-weight standard still requires us to look within the categories to make sure that we do not intentionally or unintentionally create a situation that directs credit away from fundamental needs where the risk profile has historically been low.

As you point out, in some distressed areas loans are made carefully and we do not see default rates that are out of sight.

Ms. **Uebelhoer**. If I could just add to that?

The **Chairman**. Please.

Ms. **Uebelhoer**. In conversations—I know this is just taking shape right now, but in conversations yesterday with officers of Freddie Mac, I was told that loans with high-risk loan-to-ratio-values, loans that do not qualify for private mortgage insurance, or that are higher than 80 percent LTV, would be placed in an extremely risky category and would be placed in the same category as delinquent loans, and ACORN members and low-income people who are struggling to become homeowners frequently do not qualify for private mortgage insurance and are unable to put 20 percent down on their houses. Although, with counseling we have established—and this is the work our organizations have done for 20 years—with counseling, these people, poor people, hang onto their homes and value their homes in a way I think that is almost difficult for middle class people to imagine because there is no place to go when you lose your home.

I think that is just an extraordinarily dangerous development in regulations that I hope Congress moves hastily to change.

The **Chairman**. We will take a look at that.

Ms. **Uebelhoer**. I appreciate that 80 percent loans with PMI are in a category that your staff told you they are.

The **Chairman**. We are very sensitive to the home mortgage issue. The whole reason we went to great lengths to legislate the savings and loan reform package was to put the industry back on track to conduct its traditional activities that foster housing and homeownership.

A lot of people are still complaining loudly about that focus. They ask whether we are overhoused, and whether there should be a dedicated industry that principally focuses on housing. That was the predicate for putting the reform package together a year ago.

Voices from different directions are now questioning that premise. Do we really need an industry devoted to housing? How important is housing? This gets wrapped in the larger cosmic argument about the international financial economic system. What must we do to "stay in synch with" this new global financial services marketplace.

I want to ask each of you for your thinking on that subject. It was you, Ms. Miller, who made the point that much has happened in a short space of time; we have seen change sweep the financial services industry. Electronic transmissions and other developments have changed the scene during the last decade.

Now the international economic and trading system is interconnecting ever more tightly each day. People in the financial services business tell us that, even if the United States would prefer to have its own different system, it must gear itself to integrate into the new-world system. The necessary adjustment demands an altered system, more universal, more internationally oriented. Like it or not that transformation is occurring.

They cite examples in the trade and other areas, even the environmental area. We see a set of pervasive arguments advanced by those who say the United States has to prepare itself for the new set of international conditions. That is an inescapable requirement.

How in your own minds, in your organizations, do you reconcile those international demands with your view the U.S. financial system also needs to pay attention to domestic safety and soundness issues? How do we reconcile this apparent conflict?

Ms. Ettleson, do you have some thoughts on that?

Ms. ETTLESON. I think the United States in the economy that we're in right now cannot move to an international economy without further strengthening our own economy. And to say that the backbone of all that—I would move to Jane's point on housing. Housing and a real productive economy are the backbones of our economy—real jobs. Housing is what makes our economy strong. Until we get our own economy in a strong position, only then can we move into a strong position internationally.

We cannot move internationally and leave behind the housing and the basic needs of the American people.

The CHAIRMAN. Ms. Miller?

Ms. MILLER. There are some benefits of internationalism in some areas—it is more obvious in environmental than in financial sometimes—Japan and Europe, as I understand it, are grappling with it in a different way. Even though they are moving into the international standards for purposes of capital, et cetera, they are willing to grapple with a few different mechanisms. As I understand it, European banks require a certain percentage within each bank to be invested—even though they are "high-risk" in the sense of short-term risk—in loans that support local businesses, inventions, and manufacturing. Japan does it differently, as I understand it. They do it from the top and pour it back in.

Where I feel that we are neglecting the situation is we are allowing international standards to be developed, but at the same time those standards will be very difficult to change. We are not addressing, through a more flexible approach—either through a top-down or through a bank-by-bank requirement—the need for the economy to be fairly strong. Over the last 15 years through a number of decisions, we have curtailed certain businesses—agriculture, energy—various businesses that promote more products and more jobs on a local level. Instead we have moved to a much more centralized system throughout our entire economy, and that has removed a lot of the jobs.

The relationship of these Basel Agreements is that if we do not, either through a top-down funneling of money into product-oriented business or through use of flexibility within the capital standards to invoke some sort of direction to bolster local and regional economies, we are agreeing to a financial investment policy insensitive to these national needs, thus destabilizing our economy and putting all loans at risk. If you do it only in say housing—even though we support the housing initiative because that's one of the areas we're so far lacking in—you have to equally match that with strong support in local jobs through risk-based standards supporting both. That doesn't just mean supporting the large corporations' choices for jobs which could end up in very low-paid service jobs, it's funneling money into jobs which do provide a broader variety of higher-paid skills. Because without that, you do not have the employment which then pays for that housing.

The CHAIRMAN. Let me come back to that in just a minute. I want to pursue the subject at a different level of abstraction. I do not ask for a wall-to-wall answer, because I do not know that anybody has that answer right now. But if you have some ideas, please get back to us.

Ms. UEBELHOER. Thank you, Chairman Riegle.

I heartily endorse what Ms. Ettleson had to say. I would like to pass on your question and give it some thought.

The CHAIRMAN. All right.

Let me pose a follow-on question before I yield to Senator Dixon. At the same time that the world financial and economic system is going through this minute-by-minute integration, Europe 1992 is coming on line. The European Community is attempting to rationalize its financial systems including the Glass-Steagall issue concerning the relationship between the banking and securities industries. Can you comingle different businesses, nonfinancial as well as financial?

How do we deal with these fundamental differences in structure to allow American banks try to do business in Europe?

How shall we do that? How shall we reconcile those differences? Is there a way? Is it possible to have two quite different structures that nevertheless interact constantly? And if so, what are the pluses and minuses that come from that situation?

These are huge, sweeping complex questions of enormous scale that we have not had to think about before. The on-rush of events is forcing us to answer those questions even though the answers are not yet clear.

Before I yield, let me ask one more question. Our system allows us to collect deposits in any home town in America—in Iowa, in Illinois, in Michigan, and invest them anywhere in the country, anywhere in the world. That money does not have to be reinvested in the local community.

As banks become larger and do more international business, a deposit can get collected in a small town in Iowa at 10 a.m. and by 10:15 a.m. be invested in Singapore or Taiwan or Brazil—instantaneously.

This is a long jump away from the notion that a local deposit-taking institution shall raise money and put most back into the community. Some needs to go further afield more broadly to get diversification against risk. Now the playing field is literally the whole globe, and funds are transferred instantaneously because of the revolution in communications.

How do we reconcile these two worlds—a historic but changing world of American, local finance with the increasingly integrated international environment? How do we fit these very different things together?

Can we still achieve our domestic goals of safety and soundness on the one hand, and socially beneficial credit works, allocation, on the other hand? That is the question I would like you to consider. Give us your thoughts.

The CHAIRMAN. Senator Dixon.

Senator DIXON. Thank you very much, Mr. Chairman.

I thought it was interesting, Ms. Miller, that you spent a lot of time talking about the deposit insurance question. I really think that in a simplistic way that is kind of central to everything around here that we are going to be looking at in the future.

I mean, even the extremely unpopular legislation passed that is now characterized in most of America as a "bail-out" comes back to that central question. When the administration came to us and visited with us about its plans, I recall in the beginning they were even talking about some kind of a deposit tax to raise some of the money, which was tremendously unpopular. Do you recall that? But the presentation of their case was largely based on the fact that, look, we've got this deposit insurance system. It began after the Great Depression. It reinstituted a sense of confidence in our banking system in our country. So the people think their money is safe, and they do not have to put it under the mattress anymore; they take it down to the bank, or the thrift, or whatever it is.

And now we have all these problems out here, and we have to back it up with a full faith and credit of the country behind it. I mean, that is sort of the way this whole thing was characterized when it was brought to the Congress by the administration.

I am not trying to lay blame. There is enough to go around for everybody. But all these years of deregulation, which was in fact almost no regulation, that led to this terrible tragedy for the country, and now this great American simple premise of the deposit insurance system sort of is the key to everything that has transpired since.

I think there will be a revisitation—I think it was in the Washington Post I saw this article recently. It might have been the New York Times, I don't remember—but it was kind of the usual first-trial balloon that goes out where the administration is saying, here is what we are thinking about. In there, I thought I saw the idea of cutting deposit insurance from $100,000 to $50,000. You mentioned $40,000 I think in your statement. They said $50,000, but the number doesn't matter too much. You keep hearing this talk that we're going to cut deposit insurance a maximum amount.

Well, first I would like to ask you, the three of you, just that simple thing. Do you think that has any redeeming feature of reducing deposit insurance from $100,000 to $50,000? Or from $100,000 to $40,000? Is there any value in that?

Ms. Miller. There is a little value in it in that it at least starts to grapple with the question. The difficulty is in actually achieving such actual reduction. In addition to the reduction, you would have to somehow figure out a system to insure its implementation. You would probably have to do it by household and not allow a broker-depositor to manipulate it. You would have to somehow give your regulators capacity to implement that, and that would put on some restraints.

Also, you would have to, at the same time—move to a narrow bank concept and then shift all of the other banks into some other insurance system, and simultaneously direct that the deposits are only allowed to be loaned into a decent risk definition.

You cannot just do the one part is I guess what I am saying. And even then, even then, would you be really grappling with the basic fact that the concentration in the big banks, the $10 billion banks, that if all the foreign depositors do not like their loans, say they are out of the deposit insurance system and in their own private system but they make a mistake and they loan to the wrong countries or something, so everybody starts to pull out—because we are insuring our dollar on the world level, then the Feds would move in behind them again and support all deposits anyway.

So the taxpayer backs that. I know that is not totally a separate question.

Senator Dixon. The taxpayer in fact does back it. We all know that. That is why we are in this problem now. But I would like to hear Ms. Ettleson and Ms. Uebelhoer, too.

Ms. Ettleson. I think that——

Senator Dixon. Just a basic question, to cut it in half or something.

Ms. Ettleson. Reforming the fund, you do not revoke the fund, you reform it. You reform it by protecting the fund. So I do not think that reducing it to $40,000, or $50,000, or whatever, is going to make—it is going to make a bad difference. It will have a disadvantage, because it may add some initial shock waves to the system with people moving around their money, and it will have an impact on small banks. But I think you need to add protections around the fund, whether it be $50,000 or $100,000. What it is right now is $100,000. You should be protecting around the system that we have and adding more reforms of citizen participation and other regulatory reforms like changing accounting rules or early intervention for the regulators.

Senator Dixon. Ms. Uebelhoer?

Ms. Uebelhoer. I agree. I think that reducing the level from $100,000 to $50,000 is probably a matter of indifference. The important point is attempting to protect against people attempting to play the system to win big at taxpayers expense.

So what we need to do, again, is to wrap the system in protections that prevent broker-deposits and the investment of these insured funds in risky, high-flying areas.

Senator DIXON. I think the consensus of the three of you representing consumer groups would probably be that just in and of itself it is a simplistic question and reduction from $100,000 to $50,000 does not mean much. In fact, Ms. Ettleson points out that it even could send a bad message out there that it probably could be a disadvantage in restoring a sense, or at least a perception, in our society of integrity in the system.

What about this further step? This is what I am looking at, I must be candid with you, and this is why I am asking you this: What about looking at the question of some kind of a risk-based deposit insurance system for the larger banks where there would in fact be a real insurance system out there protecting the public so in fact we would not have this mythology we have now—and I do call it a mythology—that we have got a deposit insurance system, Mr. Chairman, that just is not adequate to its challenge.

You know, we have got an insurance system without sufficient funds to meet the loss out there in our society. So when these tragedies occur, you know, then the administration says, OK, we have got to get the money to meet the challenge, first through a bond issue, but we all know in the end the taxpayer is going to pay for it. So it seems to me, and I think you would probably have to do it—in fact, what we are looking at is sort of a larger and smaller bank delineation and so forth—but a real insurance system out there that would protect the average, small individual involved in the system as basically a depositor, a person who makes application for a loan to buy a house.

Now without going into the more technical aspect of it, which will be developed here this year, what do you think of the basic idea?

Ms. MILLER. It is hard to address it without more specifics from the standpoint——

Senator DIXON. The regulators would make a determination of the larger financial institutions, at whatever capital standard we apply, as to the type of risk involved in their portfolios and so forth. On the basis of that, there would be a basic government insurance system, and then a certain percentage would be liable to be insured in the private sector, and then a certain number of points would be assessed against the institution over the basic number of points now in play to ensure in a private insurance system the basic, fundamental operating scheme of the bank.

Now that is overly simplistic, I assure you, but it is basically what we are talking about.

Ms. MILLER. The only reaction there, again, is getting back to how we are couching it, getting back to the definitions and how you would define "risk." The manipulation of that system, in our opinion, could work if we became more sophisticated in our definition of "risk." Basically that would involve—and I don't know that the regulators, even if you could evolve the definition—and what I mean by "risk" is, supposing at the current time we have risk relationships on housing that are lower than say commercial loans, but that is only relative to an assumption that in any given area there is enough businesses to keep people employed. If you risk-weight so that in a sense bank-by-bank and area by area you would have to analyze their portfolio so that their relative margins promoted an economy that was fairly flexible and stable, we are not doing that right now. We allow them to make the decisions purely on a market-driven, money-driven decision-making on the short-term so LBO's look better than something else.

If you were to risk-weight those things so that it recognized that the economy literally is part of that risk-weighting factor, then you could keep a handle on it. I do not know that that is possible to do from the standpoint of, even if you did have a margin of risk-weights it is so regional and local that it would have to be factored into your formula, that it will be difficult.

Otherwise, even if you put risk-weightings on all of the things, by the time the system, the international risk-weightings and the national ones, if you were to solve a massive problem in a given area, if you risk-weight it incorrectly or too much money had gone into one area, you would have evolved a problem that was very difficult.

So I really think that you have to look at the economic conditions as a part of the overall problem.

Ms. UEBELHOER. Yes. To take a slightly different tack than Ms. Miller did, we have long held the position that financial concentration, or concentration in the financial services industry, is perhaps the most harmful development for low-income people, so we would strongly encourage the committee and the Congress to somehow lower privileged-community controlled financial institutions and preserve those. I am not sure I am speaking directly to the deposit insurance question, but deposit insurance could certainly be used to help sustain and support the continuation of locally controlled financial institutions even in this world of mega-banking.

Thank you.

Ms. ETTLESON. I would say that at first blush it would sound like a very good idea. It seems to be the flip side of what I was saying about risk-based capital requirements. I would add to that the element that I added to the risk-based capital requirements, being not just considering the risk of an investment but the social and public interest of having particular types of investments like housing and community redevelopment and small entrepreneurs.

Senator DIXON. I appreciate your responses. I would say that I think one of the challenges that we have here is to try to figure out a way to have a deposit insurance system that works more effectively in the future when married with a good regulatory system so that we don't see a replay of what we are looking at right now.

The plain fact is that we have got a system in place that in fact is not a good insurance system. It is an insurance system that is fine when we do not have problems. Well, any insurance problem is OK if you do not have an accident. The problem we have here is that the first time we had a major accident of any great proportions in this country, the experience we have had during this last decade, we did not have an insurance system that worked. That was because the regulatory agencies, in my view, were not responsible in connection with what should have been done over the years, or in fact the system itself, the insurance system itself, was not sufficiently adequate to meet the test.

It is probably a combination of both, I might add, but I think the challenge for us is: What's broke is broke. The attempt to fix it is now going forward. I am not too happy with the beginning of that attempt, but that is a question for another day.

The question is: What are we going to do about the future with respect to the system?

Mr. Chairman, that is a real challenge.

Ms. **Miller**. Could I just add one point that I have not raised, and I know it is truly a side thing and it is not even this specific committee's purview, but I literally think it is another piece of the problem that we all tend to kind of put aside.

That is, in addition to the tools we are all talking about, it continues to strike me that we have laws. Those laws were disregarded. Everywhere we go, our member groups and people talk back to us and ask I know the general reaction to the statement, "why can't we put these people in jail?"

The reason I raise the court system—we are beginning to analyze it within CFA—in addition to coming before you to ask for changes in the law, is because we are being hit by this problem on other issues we are working on also, and we go to the other committees and they are saying, when are you guys going to take this stuff to court? We have got the laws. But the court system is literally falling apart.

Senator **Dixon**. Could I interrupt to respond to that part. I wish you could have been in the room sometimes, and I think a majority, in all fairness, of both sides of this committee have said to us, "When are you going to put those people in jail?" There may be thousands, or tens of thousands of them out there, and that should be done.

Second, when are you going to start suing under the "reasonably prudent man" rule all kinds of rich people out there that were involved in these institutions?

When I was a kid, I was on the board of directors of a bank in a small town in Illinois. I can remember how we used to agonize over some of our loans because of the "reasonably prudent man" rule that said that you could get sued as a member of the board of directors if you made a mistake. All those billions out there must represent, first of all, a lot of fraud; and second, a lot of criminality, but beyond that a lot of negligence.

Nobody is being sued, and nobody is being put in jail. But again that comes back to the fact that that is all water over the dam from the standpoint of what we can do in the Congress. That is a thing, though, that can be done by a lot of people in the Government, and I would hope they are doing it.

The **Chairman**. That is a very widely shared frustration. There was a case the other day in Texas where somebody was found guilty and sentenced to 30 years in prison. That case is having a big impact.

In the savings and loan reform package, the administration asks us to include $50 million in a year for each of the next 3 years to track down the crooks and wrongdoers and to try to get some recoveries. We increased the allotment to $75 million a year for 3 years. Yet we hear that not all of that money is being spent. The cases are complicated and take a lot of qualified lawyers to reconstruct the trail, get convictions, and also to affect recoveries.

About 500 institutions have failed in just the S&L industry. So we have a failure problem of vast size. How do we prevent parallel problems from occurring in commercial banking? How do we protect the bank deposit fund?

These industries are different. We had 18 days of record to reconstruct, in very fine detail, the causes, the catastrophic collapse in the S&L industry.

One not well understood aspect, was an anomaly in the law governing Federal deposit insurance. The individual States could charter savings and loans within their States, retain local control and State autonomy but obtain Federal deposit insurance.

Some States so broadened the authority of State-chartered savings and loans that they created an entirely different risk profile. Now, when we look back, we find that the lion's share of the losses occurred in those States, and in those State-chartered thrifts that had very broad powers beyond those authorized in the Federal charter. Yet, every single dollar of the State-authorized activities was protected by the Federal deposit insurance fund.

A substantial amount of the money that is now being paid to depositors is going to those State-chartered thrifts.

One of the most powerful facts I learned is that in 1988 70 percent of all of the S&L losses occurred in just 2 States—Texas and California. Those were the States with the wide-open charters.

Just to give you one illustration, the Federal charter for savings and loans coming through the latter part of the 1980's allowed individual thrifts to have up to 11 percent of their assets in junk bonds. The State of California allowed State-chartered thrifts to hold more junk bonds. One thrift had almost 34 percent of its assets in the form of junk bonds. So you look at that and you say, how do I rationalize this difference?

Now I think there are some analogies here, if you jump all the way back over to my other question between how do we integrate, begin to integrate the American economic and financial system into the global financial system? Because you see the equivalence of a much broader playing field and different kinds of activities and so on going on in banking institutions in other countries.

When we wrote that savings and loan legislation a year ago, we stopped every single abuse that we could find—every single one. We put an end to the abuse of State powers. That is gone. We put an end to the abuse of direct investments in real estate, which was a large part of the loss package and so forth.

We redirected the industry back into the areas where traditionally it had been. In every single area where we could find a defect, we built in a precise remedy.

A lot of people do not like it. The act tightens down and requires people to raise capital, to put their own money at risk before taxpayers' money is at risk.

A lot of people think this bill is too tough. I have heard hardly anybody say it is not tough enough. The near-universal complaint is that it is too tough; it is too arbitrary; the standards are too high; there is not enough time given for adjustment.

You know that, it is in the newspapers. I am just one member of this committee but I think the bill is designed to stop the abuses, and it is doing that. The bill is in place. It needs to have time to work. You have got to have a team on the field. For the better part of 8 months, we did not have a full team on the field because a lot of jobs were not filled. There has been some controversy about that. The jobs are now filled. So now the legislation deserves an opportunity to work.

But now the question is different—where do we go now with the banking system? Now we have under the FDIC of course two funds. Senator Dixon expressed a concern about the strength of the insurance system on the banking side.

The BIF fund that insures bank deposits has around $13 billion right now. But it supports well over a trillion dollars in outstanding liabilities—set of liabilities of extraordinary size.

How do we make sure that that bank insurance fund is solid and safe and not put into jeopardy? I do not want to see anything done to put that system under any more stress, in any more jeopardy. I want to strengthen it. I want to figure out how to make the insurance system under the commercial banking industry stronger, measurably stronger.

How to do that and, at the same time, reconcile the system to the global revolution is very, very difficult. We can start with a philosophy or a theory, but practical problems in writing the rules, regulations, capital standards, risk-based premiums to engineer the mechanics to give you the result you want.

As we start these hearings, I am not sure that any of us has a very clear view of what engineered structure is needed. That is why I have asked you to include our international needs in your recommendations.

This year we have scheduled some international witnesses in our hearing schedule. They will be seated where you are today. Someone will represent the European Community, somebody will represent the Japanese viewpoint. This will help us understand the international realities. As representative of the consumer perspective, you may want to cover those hearings so to better understand what will be an enormously complex task.

The S&L situation is different. There we are going back and cleaning up a succession of errors, mistakes and miscalculations that built up over a decade. State powers, insufficient regulation, fraud, poor accounting practices, and a series of other things compounded into a very large systemic failure.

We cannot afford to have that happen in the banking system. We absolutely cannot afford to have that happen. The impact on communities and people's lives would be too great. We cannot afford that kind of risk to the center of our financial system.

I am not one to make leaps of faith. I have been chairman here for only a little over a year. I want the work that comes out of the committee during the time that I am chairman to be engineered properly because we know what we are doing. Then we will monitor the results closely to make sure that our intentions are being carried out the way intended. I want to know the consumer viewpoint. You folks represented, through your separate organizations, lots of different consumer points of view. There may be others. We want to give everybody a chance to be heard.

I want the consumer interest to be right in the center of our evaluation, discussion, and debate.

Ms. Miller you indicated you have some thoughts on the loan to one borrower issue. Do you want to comment on that?

Ms. **Miller**. The loan to one borrower issue is an issue where even though CFA did not take a lead, we believe current FIRREA law should be upheld, strongly upheld. I would not like to comment further at this time.

The **Chairman**. Does anybody have any final comment?

[No response.]

The **Chairman**. I want to maintain a dialog here. I would like each of you to address the broader question I raised of integrating into the world economy. I will look forward to receiving your thoughts after you have had time to reflect. There is no urgent deadline.

Thank you, very much.

The committee stands in recess.

[Whereupon, at 11:30 a.m., the hearing was adjourned.]

DEPOSIT INSURANCE REFORM AND FINANCIAL MODERNIZATION

TUESDAY, APRIL 24, 1990

U.S. Senate,
Committee on Banking, Housing, and Urban Affairs,
Washington, DC.

The committee met at 10:30 a.m. in room SD–538, Dirksen Senate Office Building, Senator Donald W. Riegle, Jr. (chairman of the committee) presiding.

Present: Senators Riegle, Dixon, Shelby, Garn, and Pressler.

OPENING STATEMENT OF CHAIRMAN RIEGLE

The **Chairman**. The committee will come to order.

Let me welcome our witnesses and all those in attendance this morning.

This is the third of our hearings on modernizing America's financial system, reforming Federal deposit insurance, and maintaining the international competitiveness of U.S. financial institutions.

In recent years old barriers in the world of financial services have been steadily eroded by market forces and the exploitation of statutory loopholes. In the 2 years since the Senate passed the Proxmire Financial Modernization Act, these trends have continued, heightening the need for comprehensive reform of our financial system. America's financial institutions must effectively serve this Nation's credit and investment needs and remain strong competitors overseas.

Two conditions must be met for financial modernization to proceed. First, our deposit insurance system must be reformed. The deposit insurance funds and the taxpayers who stand behind them need greater protection against current levels of risk to our depository institutions. Proposals to increase those levels without safeguarding the deposit insurance funds are just unworkable.

Second, our system of financial institutions regulation needs to be rationalized and simplified. We need greater confidence that it really is a system—not just an amalgam of agencies and offices pursuing separate agendas—and that it can adequately monitor and respond to all the risks present in modern financial service conglomerates. In this connection, I note that the Financial Services Council would like to eliminate the barriers between banking and commerce. I will be particularly interested in how they would provide for coherent and effective regulation of the entire holding company structure.

So we have asked the witnesses today to focus primarily on three questions. First, how should the current system of Federal deposit insurance be reformed? Second, what should be done to improve the current regulatory structure? And finally, should new powers be granted to banks or their affiliates? And if so, what powers should be granted, when should they take effect, and with what protections for the deposit insurance fund?

Our witnesses this morning are Kenneth Whipple, the president of Ford Financial Services Group, who will testify for the Financial Services Council; Philip Vallandingham, the president of the Independent Bankers Association of America; and David Silver, the president of the Investment Company Institute.

We welcome them and look forward to hearing their testimony. Senator Garn.

OPENING STATEMENT OF SENATOR GARN

Senator **GARN**. Thank you, Mr. Chairman.

Today we continue the committee's series of hearings on modernization of the financial services industry. I commend the chairman for holding these hearings, although I mentioned to Mr. Silver that both he and I have made a career I think of talking about the Glass-Steagall Act, at least the last decade and a half for me and probably longer for David; but I certainly hope that these hearings will result in being the definitive ones and certainly finally result in some congressional action.

One of the most striking changes I have observed is that finally, after all the years of some of us having been advocating change, there is a growing consensus that change is inevitable and necessary, if our financial services industry is to recover its place in the world and remain strong.

As a result of this consensus, considerable progress has been achieved in narrowing the debate and focusing the creative energies of industry, Government and the consumer representatives on financial modernization.

These hearings provide a forum for us to get the benefit of that focus and energy.

Today's witnesses certainly represent some of the key components in our financial services system.

Gentlemen, I am pleased you are here and look forward to your testimony.

The **CHAIRMAN**. Thank you, Senator Garn.

Let me say to all of you that we will make your full statements a part of the record and we would appreciate and welcome your summarizing your remarks and going right to the points that you want to most emphasize for us.

With that, Mr. Whipple, we will start with you.

STATEMENT OF KENNETH WHIPPLE, PRESIDENT, FORD FINANCIAL SERVICES GROUP, ON BEHALF OF THE FINANCIAL SERVICES COUNCIL

Mr. **WHIPPLE**. Thanks, Mr. Chairman.

As you said, I am Ken Whipple. I am head of the Ford Financial Services Group which comprises the financial services companies that are part of Ford Motor Co.

Just very briefly, that consists of the Ford Motor Credit Co. which is based in Dearborn, MI; The First Nationwide Thrift Organization which is headquartered in California; The U.S. Leasing International Commercial Financing and Leasing Operation, also based in California; and The Associates which is headquartered in Dallas, TX, and is a diversified financial services company and our most recent acquisition.

Adding those organizations up together in terms of assets, there are about $115 billion, which makes us one of the larger financial services companies in the United States. We also have a fair number of operations abroad, including a significant operation in Japan.

I am here today on behalf of the Financial Services Council and I have with me Mr. Sam Baptista, who is president of the council.

The council, as you may know, consists of 25 of the top financial services companies in the country. It includes insurance companies, thrifts, banks, securities companies and diversified financial services companies. These companies represent a very wide range of views on almost any subject you can think of, but we have been able to reach a consensus together on how we would restructure the financial services business in this country.

Our vision of a competitive U.S. financial services system is one that ensures safety and soundness for sure, one that also has maximum customer choice of financial products at reasonable prices, and enhances the competitiveness of the U.S. financial sector in the global marketplace. And we think we have to address all of these points.

We think that S. 530, which Senator Garn is a part of, can help achieve this vision. It would create a legal structure that would permit any well-capitalized, well-managed company to bring its capital and to bring its management to the financial services business in any sector.

S. 530 provides for functional regulation of each separate financial service business, along with enhanced safeguards to ensure that safety and soundness of the banking system and the deposit insurance system.

We think there's a growing consensus in this country for comprehensive reform, including the FDIC and including some of the regulatory agencies and including administration officials and some industry spokesmen as well.

I would like to respond specifically, Mr. Chairman, to the three questions that the committee raised and then outline why we think this financial services modernization is so urgently needed and also why we think S. 530 will help achieve the modernization.

As you recapped, you asked for our views on new powers that should be granted to financial institutions, on regulatory changes and what changes are recommended for the deposit insurance system.

On the powers question, we support S. 530's comprehensive reform as opposed to the other approach that we could consider taking, which is a series of piecemeal changes to the present system.

As you know, S. 530 would permit the establishment of depository institution holding companies which would have the power to participate in any financial services business.

As to regulation, one of the critical points—and here we agree with FDIC Chairman Seidman who said in recent testimony that we must make sure to isolate banking activities from the risks associated with nonbank affiliates without spinning a regulatory web around the entire organization. In other words, we need to have very strong functional regulation to be sure, but we have to avoid regulations and guidelines that are so onerous that they defeat the overall objective that we're headed for on reform. We have to attract new participants and new capital, but companies won't choose to invest if the restrictions are so severe that they compromise flexibility and the chance at a reasonable return.

S. 530 includes provisions to protect the safety and soundness of the system, including application of meaningful capital standards, firewalls to insulate the depository institution from nonbanking affiliates, better regulation and supervision, and earlier intervention with respect to problem institutions.

On the issue of deposit insurance, we think there is a need to instill greater market discipline. While there is certainly a need to protect small depositors who in the end really don't have the expertise or the resources to assess market risk factors, it may not be appropriate to fully extend such protection to sophisticated or large investors. We think that some of these sophisticated depositors should bear some of the risk and that the so-called too-big-to-fail doctrine should be re-examined.

Adequate capital is a very important safeguard for insured deposits. A key problem with the present system we think has been a failure to enforce meaningful capital standards and to deal promptly with problem institutions.

Under S. 530, the appropriate regulator can immediately step in and implement actions to protect the depository institution if there is either a problem or if the institution violates a regulatory requirement, including minimum capital standard requirements.

We think financial services reform should be high on the congressional agenda. In the United States, market forces are already breaking down artificial regulatory barriers as companies seek ways to meet rising customer expectations and increase competition. There are lots of examples of this.

For example, money market mutual funds, share drafts, and NOW accounts all were created to compete with checking and deposit accounts in commercial banking. In the end, the customers are going to determine the financial products that get offered and we have to make sure that they are offered in the most efficient way.

In addition to that, today we certainly operate in a global financial marketplace. This is also translated to increased foreign investment here at home. Foreign banks now account for about a quarter of U.S. banking assets and more than a quarter of commercial and industrial loans. In addition, foreign institutions are aggressively developing worldwide capability. To get ready for the new European marketplace, for instance, European financial services firms are rapidly expanding their capabilities and combining, which will permit them to become more efficient competitors on a worldwide basis.

Meanwhile, technology is increasingly becoming sophisticated and is blurring geographic boundaries and forcing the integration of national and international markets. For example, I didn't know until quite recently that there are more automatic teller machines in Japan than there are in the United States and the technology level is significantly higher.

But while global competition has increased and technology offers the potential of better products and lower costs at the same time, the extent to which U.S. financial institutions can take advantage of these opportunities has been and is limited by statutory and regulatory constraints.

Our major experience at Ford of course is in the car and truck business, but we think this experience is also quite relevant to the challenges that face the financial services business, particularly in the international marketplace.

In the car and truck side of things, we have been able to substantially improve in the face of higher foreign competition and it's not rocket science—it's by essentially paying attention to the basics—investing in the technology, increasing productivity, cost efficiency, emphasizing quality, and listening to what the customers want. Unfortunately, some of these strategies won't be available in the financial services business unless the regulatory system is modernized.

We think the arguments against such restructuring aren't valid. There are essentially two of these arguments. One is the fear of too much economic concentration and the second is worries about barriers between commerce and banking.

There certainly will be some consolidation in this country, but even looking at the spread of distribution now, for example, the thrift organizations that is a part of Ford, is on most measures about the third largest thrift in this country. It has less than 2 percent of the insured deposits. We think that the issue of economic concentration is not an issue.

In addition to that, the U.S. antitrust and bank control laws are designed to prevent consolidations that aren't in the public interest.

The line between banking and commerce doesn't exist in most countries the way it does here and is only a recent change in fact here in the United States. Again, Chairman Seidman has said, "There is little need for concern about safety and soundness, conflict of interest or undue concentration in this regard." In fact, I think we could look back at history and see there is no evidence that there have been problems created by various combinations of banking and commerce.

Our council believes the four principles that are embodied in S. 530 are key to a competitive financial services industry and I'll close just by running through those briefly.

First, by eliminating all barriers to entry for institutions that meet the test, the test of financial soundness and the test of management capability. By opening the industry, we think that's the only way that we can be as good as we can get in this business.

Second, by taking away the anticompetitive barriers and providing equal treatment and equal powers. We need to expand the scope of activities that these institutions can participate in. The key to attracting new participants and new capital is having an industry that's viable and healthy and does provide at least the opportunity to earn a decent return on investment.

Third, providing the functional regulation without regard to ownership, control or affiliations. We think regulation is most effectively conducted by the agency with the greatest expertise. Consequently, regulation of banks and thrifts should remain with their appropriate regulators; regulation of insurance by the respective State insurance commissions; and securities with the SEC. Public companies have a wealth of information that's available from a control standpoint at the present time.

And last, providing enhanced safety and soundness of the U.S. banking and deposit systems. S. 530 would apply strict application of the meaningful capital standards. It would have firewalls in place. It would enhance regulation and supervision of the depository institution and permit early intervention to protect the U.S. banking and deposit insurance systems.

We think the time has come to modernize the structure of the U.S. financial system. In the absence of reform, U.S. financial institutions will find it increasingly difficult to serve the needs of their customers in the most efficient way not only here but in the world markets. The Financial Services Council thinks that S. 530 provides a workable framework for this modernization. Thank you, Mr. Chairman.

[The complete prepared statement of Kenneth Whipple follows:]

STATEMENT OF KENNETH WHIPPLE

PRESIDENT, FORD FINANCIAL SERVICES GROUP

ON BEHALF OF THE FINANCIAL SERVICES COUNCIL

BEFORE THE

COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS

UNITED STATES SENATE

ON LEGISLATION TO MODERNIZE

THE REGULATION OF FINANCIAL SERVICES

APRIL 24, 1990

Executive Summary
Statement of Kenneth Whipple
President, Ford Financial Services Group
On Behalf of The Financial Services Council
United States Senate
Committee on Banking, Housing and Urban Affairs
April 24, 1990

The Financial Services Council was formed in April of 1987 with the goal of promoting the development of an open and competitive financial services industry. It includes banking, thrift, insurance, securities, finance and diversified financial services companies.

Our vision of a competitive U.S. financial system is one that ensures safety and soundness, increases the choice of financial products at reasonable prices and enhances the competitiveness of the U.S. financial sector in an increasingly global marketplace.

We believe that S.530, the Depository Institution Affiliation Act introduced by Senators D'Amato, Cranston and Garn, can achieve this vision. It would create a legal structure that would permit any well-capitalized, well-managed company to enter any sector of the industry. It provides for functional regulation of each separate financial service business and enhanced safeguards to ensure the safety and soundness of the U.S. banking and deposit insurance systems.

Consensus is building for this kind of reform. FDIC Chairman Seidman, other regulators, Administration officials and industry spokesmen have advocated similar changes.

The testimony will respond to three questions raised by the Committee and then outline why we believe financial services modernization is so urgently needed and why S.530 is the right approach.

The Committee asked for our views on what new powers should be granted to financial institutions, what regulatory changes are needed and what changes are needed to the deposit insurance system.

With regard to powers, we support S.530's comprehensive reform as opposed to piecemeal changes to the present system. S.530 would permit the establishment of depository institution holding companies ("DIHC"), which would have the power to participate through subsidiaries in any financial services business.

As to regulation, it is critical that, as FDIC Chairman Seidman indicated in recent testimony, we "isolate banking activities from the risks associated with non-bank affiliates, without spinning a regulatory web around the entire organization." Until such time as comprehensive regulatory reform is achieved, we believe it would be premature to change or consolidate the regulatory function.

The key is to avoid regulations and guidelines that are so onerous they defeat the overall objectives of reform. The industry needs to attract new participants and new capital, but companies will not choose to invest if the restrictions are so severe that they compromise flexibility and the ability to earn an adequate return on investment.

S.530 includes provisions to protect the safety and soundness of the system, including: strict application of meaningful capital standards; firewalls to insulate depository institutions from non-banking affiliates; enhanced regulation and supervision of the depository institutions; and early intervention on capital-impaired depository institutions.

Turning to the issue of deposit insurance, we believe there is a need to instill greater market discipline. While there is a need to protect small depositors -- who may not have the expertise or resources to assess market risk factors -- it may not be appropriate to fully extend such protection to sophisticated or large depositors.

The Council believes that sophisticated depositors should bear some of the risk and that no institution should be considered "too big to reorganize."

Adequate capital is the most important safeguard for insured deposits. A key problem with the current deposit insurance system has been the failure to enforce meaningful capital standards and to deal promptly and decisively with insolvent institutions.

Under S.530, the appropriate regulating agency can immediately step in and implement actions to protect the depository institution if it either detects a problem or if the depository institution violates any regulatory requirements, including minimum capital adequacy requirements.

The Council believes that financial service reform should be high on the congressional agenda. Market forces are breaking down artificial regulatory barriers as companies seek ways to meet rising consumer expectations and increased competition.

Moreover, today we operate in a global financial marketplace. This has translated to increased foreign competition at home. Foreign banks now account for about 23 percent of U.S. banking assets and more than 28 percent of commercial and industrial loans.

In addition, foreign institutions are aggressively developing worldwide capability. To prepare for the new European marketplace, European financial services firms are rapidly expanding their capabilities, which will permit them to become more efficient competitors on a worldwide basis.

Meanwhile, technology is increasingly sophisticated and has blurred geographic boundaries and forced the integration of national and international markets.

But while global competition has increased and technology offers the potential of better products and lower costs, the extent to which U.S. financial institutions can take advantage of these opportunities has been limited by statutory and regulatory constraints.

The Council believes the arguments against such restructuring -- generally a fear of concentration and worries about barriers between banking and commerce -- are not valid. While some institutions will consolidate to compete internationally, there always will be a need for institutions that specialize in serving local needs. U.S. antitrust and bank control laws are designed to prevent consolidations that are not in the best interest of the public.

The delineation between banking and commerce is only recent and FDIC Chairman Seidman has said that there is little evidence of concern about safety and soundness, conflict of interest or undue concentration.

The Financial Services Council believes the four principles embodied in S.530 are key to a competitive financial services industry.

- First, eliminating all barriers to entry for institutions that meet tests of financial soundness and prudent operation. By opening the industry to a broader range of participants, S.530 could enable the financial services industry to attract much needed capital to meet higher capital standards and increased competitive pressures.

- Second, removing anti-competitive barriers by providing equal treatment and powers. We need to expand the scope of activities in which an institution, or affiliates of that institution, can participate. The key to attracting new participants is a viable, healthy industry that offers investors the opportunity to earn a reasonable return.

- Third, providing functional regulation without regard to ownership, control or affiliations. We believe regulation is most effectively conducted by the agency with the greatest expertise. Consequently, regulations of banks and thrifts should remain with the appropriate bank and thrift regulators, regulation of insurance by the respective state insurance commissions and securities with the Securities Exchange Commission.

- Fourth, providing enhanced safeguards to ensure the safety and soundness of the U.S. banking and deposit insurance systems. S.530 would apply strict application of meaningful capital standards; maintain firewalls to insulate the depository institution from non-banking affiliates; enhance regulation and supervision of the depository institution; and permit early intervention to protect the U.S. banking and the deposit insurance systems.

The time has come to modernize the structure of the U.S. financial system. In the absence of reform, U.S. financial institutions will find it increasingly difficult to serve the needs of their customers and compete in both U.S. and world markets. The Financial Services Council believes S.530 provides a workable framework for this modernization.

Statement of Kenneth Whipple
President, Ford Financial Services Group
On Behalf of The Financial Services Council
United States Senate
Committee on Banking, Housing and Urban Affairs
April 24, 1990

Mr. Chairman and Members of the Committee, I am Kenneth Whipple, President and Chief Executive Officer of the Ford Financial Services Group, the financial services business of Ford Motor Company. The Financial Services Group consists of Ford Credit, First Nationwide, U.S. Leasing and The Associates. Our asset base of $115 billion makes us one of the largest financial services companies in the United States. Our primary market is domestic, but we have some consumer and commercial operations abroad, including a significant operation in Japan. I am appearing today on behalf of the Financial Services Council ("Council") of which we are a member.

The Council appreciates this opportunity to appear before the Committee. We are encouraged by the Committee's recognition of the changing financial services marketplace and the corresponding need to modernize our nation's financial regulatory structure.

The Council was formed in April of 1987 with the goal of promoting the development of an open and competitive financial services industry. It includes banking, thrift, insurance, securities, finance and diversified financial services companies.

Our vision of a competitive U.S. financial system is one that ensures safety and soundness, increases customer choices of financial products at reasonable prices and enhances the competitiveness of the U.S. financial sector in an increasingly global marketplace.

We believe that S.530, the Depository Institution Affiliation Act, introduced by Senators D'Amato, Cranston and Garn, can help achieve this vision. It would create a legal structure that would permit any well-capitalized, well-managed company to enter any sector of the industry. It provides for functional regulation of each separate financial service business and enhanced safeguards to ensure the safety and soundness of the U.S. banking and deposit insurance systems.

A consensus is building for this kind of reform. FDIC Chairman William Seidman, other regulators, Administration officials and industry spokesmen have advocated similar changes.

The key issues in reforming the financial services regulatory system are identified by the Committee in the questions you asked: 1) what new powers should be granted to institutions; 2) what changes are needed to the regulatory structure; and 3) what changes are needed to deposit insurance.

The Council believes that S.530 provides the proper framework for addressing these issues.

New Powers. There are two directions that can be taken with respect to new powers. We could attempt to patch up the existing system by granting new powers in some instances and eliminating certain restrictions. Or we can move away from a piecemeal approach and implement a comprehensive plan to restructure and modernize the industry.

S.530 would take a comprehensive approach. It would permit the establishment of Depository Institution Holding Companies ("DIHC"). A DIHC would be exempt from the ownership and activity restrictions of the Bank Holding Company Act, the Glass-Steagall Act, or the Savings and Loan Holding Company Act. A DIHC would have the power to participate through subsidiaries in any financial services business, subject to functional regulation and to certain additional restrictions designed to insulate the depository institution from its non-insured affiliates. The DIHC structure would be entirely optional. Any company wishing to continue under its present regulatory structure could do so.

Regulatory Structure. In S.530, expanded powers are accompanied by provisions that protect the safety and soundness of the system, including:

- strict application of meaningful capital standards;
- firewalls to insulate the depository institution from non-banking affiliates -- including restrictions on transactions between affiliates, restrictions on the activities of insured depository institutions, change of control rules and restrictions on dividend payments;
- enhanced regulation and supervision of the depository institution, supported by adequate resources; and
- early intervention, including prompt reorganization or divestiture of capital-impaired depository institutions.

Under S.530, financial service affiliates within the new holding company structure would be separately capitalized and regulated along functional lines, without regard to ownership, control or affiliation. The Council believes that the focus of any regulatory oversight should be to protect the depositors in federally-insured institutions and the safety and soundness of the system, as opposed to imposing new regulations on non-regulated affiliates.

We would note that regulatory safeguards cannot be established to regulate to the "lowest common denominator" without the potential for regulations and guidelines that are so onerous they defeat the overall objectives of reform. The industry needs to attract new participants and capital, but companies will not choose to invest if the restrictions are so severe that they compromise flexibility or the ability to earn an adequate return on investments.

We need to redirect the focus of our attention on creating an efficient, profitable and customer-oriented financial services industry, and address the issue of enforcement through adequate oversight and examination, early detection and intervention, and appropriate civil and criminal penalties.

We agree with FDIC Chairman Seidman, who indicated in his recent testimony, "The removal of constraints will only be effective if we can isolate banking activities from the risks associated with non-bank affiliates, without spinning a regulatory web around the entire organization." Until such time as comprehensive regulatory reform is achieved, we believe it would be premature to change or consolidate regulatory functions.

Deposit Insurance. Turning to deposit insurance, there is a need to instill greater market discipline. While no one argues that small depositors -- who may not have the expertise or resources to assess market risk factors -- need protecting, it may not be appropriate to fully extend such protection to sophisticated or large depositors.

Although we have not advocated a specific approach, many Council members believe that sophisticated depositors should bear some of the risk and that no institution should be considered too big to reorganize. This should enhance the overall stability of the system by restoring depositor discipline and providing pressure to close troubled institutions early.

The most important safeguard for insured deposits is adequate capital. The recent savings and loan crisis was the result of many factors, but in large part it stemmed from a failure to enforce meaningful capital standards and to deal promptly with insolvent institutions. S.530 would provide important protection for deposit insurance through: 1) better enforcement of capital standards; and 2) earlier warning and action on capital deficiencies.

S.530 includes "capital beardown" provisions to enforce capital standards at the first-sign of capital deficiency if the parent company is unable or unwilling to restore the institution's capital to a minimum regulatory level.

Under S.530, the appropriate regulator can immediately step in and implement actions to protect the depository institution if it either detects a problem or if the depository institution violates regulatory requirements including minimum capital adequacy requirements. These actions include restrictions on asset growth, issuance of injunctions or restraining orders, appointment of a conservator for the insured institution or the requirement for prompt divestiture or reorganization of the depository institution.

The power to require prompt divestiture or reorganization of the depository institution would represent a major new safeguard. We believe this would provide a powerful incentive because reorganization or divesture would be required while owners still have equity in the institution. Forced divestiture could eliminate the value of this equity.

I would like to discuss two other areas -- first, why we believe reform is so urgently needed; and second, the overall benefits of S.530.

Need for Reform and Modernization. There are very substantial reasons to proceed with prompt financial service reform. The present U.S. financial system, and the complex structure of government regulation that surrounds it, were shaped by the Depression and the inward looking environment of the 1930s and 1940s. However, a system that was appropriate in the earlier part of this century is not necessarily one that is best suited for our needs in the 1990s and beyond.

In the United States, our compartmentalized financial system is breaking down as companies try to find ways to avoid the constraints of regulation in order to meet customer expectations. Companies precluded from offering a product directly are sometimes able to offer a substitute that meets customer needs. For example, money market mutual funds, share draft accounts and NOW accounts were created to compete with checking and deposit accounts in commercial banks. Insurance companies offer annuity products to compete with long-term CDs at depository institutions.

Consumer demand for "one stop shopping" also has caused some companies to combine a variety of financial products. One example is the popular cash management account, which allows an individual to invest in securities, hold insured deposits, have a line of credit and a credit card, and control all of these through one source.

Moreover, today we operate in a global financial marketplace. This has translated to increased foreign competition at home. In total, 281 banks from 56 countries have nearly 700 full service bank offices in the United States. Foreign banks account for about 23 percent of U.S. banking assets and more than 28 percent of commercial and industrial loans.

The capability to compete on a world basis is being nurtured in other countries. For example, by year-end 1992, Western Europe will be a market of 320 million people with a gross national product of $5 trillion, comparable to the U.S. economy. Physical, technical and fiscal barriers between European countries will be reduced by the European Community along with barriers between the Eastern and Western Blocs.

To prepare for the new European marketplace, European financial services firms are moving aggressively to expand their capabilities. For example, Banque Nationale de Paris and Union de Assurances de Paris, respectively France's largest bank and insurance company, have announced an alliance. The Deutsche Bank, West Germany's largest bank, recently announced it was getting into the life insurance business through a subsidiary and is moving aggressively into Eastern Germany. In the United Kingdom, Lloyd's, a major clearing bank, recently purchased Abbey Life, a top insurance company. Europe's biggest insurance company, Allianz, recently announced a marketing arrangement with West Germany's second largest bank, Dresdner Bank. All of this activity is positioning European institutions to become more efficient competitors on a worldwide basis. However, American financial institutions are impeded from forming many of the strategic alliances being pursued by our foreign competition.

Meanwhile, by year-end 1988, 15 of the top 20 largest banks in the world were Japanese. As of October 1989, all top 20 financial firms, ranked by market capitalization, were Japanese. By comparison, in 1983, only three of the largest banks in the world were Japanese.

Japanese financial firms have made substantial inroads in the United States as well. Today, Japanese firms underwrite, trade and manage for investors all types of securities in our equity and fixed income markets and are even included in the exclusive group of primary dealers. They also plan to offer credit cards to Americans. Japanese commercial banks offer products and services to Americans in most major markets -- accounting for 12 percent of total U.S. deposits. And this percentage is likely to increase. Japanese financial institutions control some 25 percent of the banking assets in California, a state that they traditionally have used as a springboard for expansion into other U.S. markets. Japanese companies are particularly skilful at using technological advances to build market share. It is particularly worrisome, therefore, that 38 percent of ATM's worldwide are in Asia compared to 28 percent in North America. The trend toward global markets is certain to increase.

Meanwhile, technology has blurred geographic boundaries and forced the integration of national and international markets. Customers have continued access to their funds 24 hours a day through the use of ATM's or telephones. Trading on equity and fixed income markets in Tokyo, London and New York is linked. It is possible for someone to initiate a financial futures position in Chicago and close it in Singapore.

Moreover, technology is becoming increasingly sophisticated. Revolutionary changes in computers and telecommunications have created opportunities to handle information more effectively and efficiently, and facilitated the development of improved products. Mechanization of backroom operations has facilitated the handling of transactions by reducing both the processing time and cost. Banks have developed information systems that allow branch personnel to access information about a customer's total account relationship with the depository, as well as bring to the customer's attention information from various products and services offered. By using portable computers, First Nationwide's loan officers soon will be able to take mortgage applications in customers' homes and give them approval within a matter of minutes.

But while technology has offered the potential of better products and services, increased efficiency and lower costs, the extent to which U.S. financial institutions can take advantage of these opportunities has been limited by statutory and regulatory constraints. While technology would allow us to offer convenient "one stop" shopping to customers who want such service, our current fragmented system constrains us from providing customers with these choices. In many cases, financial institutions have found ways to overcome the constraints -- as noted above -- but only by introducing inefficiencies and incremental costs.

For example, Ford through The Associates, owns a credit card bank. But The Associates is limited to consumer credit card operations. Commercial credit card operations can be conducted through First Nationwide, but growth is limited because we must maintain a high percentage of our assets in home mortgages. Ford's ability to participate effectively and serve credit card customers in the most efficient and low cost manner is hampered by the need for two separate delivery systems.

Ford Motor Company has faced global competitive and technological challenges in the automotive industry. The pace of technological change has accelerated, consumer expectations have increased dramatically and foreign competition is greatly intensified. We believe we have been successful in meeting these challenges by making quality "Job #1," cutting costs and improving efficiency, listening to customer wants and needs, and meeting or exceeding foreign competitors in technology, product and value.

These strategies have been successful. Despite increased competition from European and Asian manufacturers, Ford Motor Company increased its market share during the 1980s. We would like to use this same successful strategy with our financial service products. We would like to provide convenient and innovative products, while taking advantage of new technology and seeking efficiencies between our financial service affiliates. However, neither Ford nor other U.S. financial service providers will be able to meet the customer demand for increasingly sophisticated and convenient products unless our regulatory system is modernized to allow us the flexibility to provide these products.

Even though the case for changing the system is a strong one, there is considerable reluctance to change. One reason often cited for preserving the current system is to avoid undue concentration of economic power. The challenge is to permit the consolidation necessary for us to become global competitors, while preserving the local bank system. There is no reason this cannot be achieved. There are about 15,000 banks and thrifts in the United States. There is no question that some institutions will consolidate to compete internationally, but there always will be a need for institutions that specialize in serving local needs. In addition, U.S. antitrust laws and laws governing bank control will prevent consolidations that are not in the public interest.

Another reason cited for not modernizing is the fear of dissolving the barriers between banking and commerce. In fact, in a 1987 study, the FDIC noted that "there has never been a complete separation of finance and commerce in the history of American banking." Affiliations between commercial banks and non-banking firms continued until 1970 when the Bank Holding Company Act was amended, and there are still exceptions today.

FDIC Chairman Seidman, in his recent testimony before the House International Competitiveness Task Force Committee on Banking, Finance and Urban Affairs indicated, "There is little evidence of any bank safety-and-soundness concerns, conflict-of-interest abuse or undue concentrations of resources from the interaction of banking and non-banking activities either here, or abroad where much greater interaction has traditionally been permitted."

Manufacturing and retail companies already are significant players in the financial services industry. At the end of 1988, according to the American Banker, the five largest finance companies in the United States were affiliated with non-financial services companies, as were most of the other 50 largest finance companies. In addition, commercial entities own thrifts, credit card banks, and securities, insurance and leasing companies (e.g., GE owns Kidder Peabody, Sears owns Allstate, Coldwell Banker, Dean Witter and Greenwood Trust). In fact, commercial banks are the only type of financial services companies that commercial entities are prohibited from owning.

We need to recognize that a prohibition on affiliations between banks and commercial firms is not necessary to protect the financial system from abuse, and that barriers to entry must be eliminated in order to provide the banking industry with new sources of equity capital and management.

S.530. In summary, I would like to leave you with the four principles embodied in S.530 that we believe are key to a competitive financial services industry.

1. Eliminate all barriers to entry for institutions that meet tests of financial soundness and prudent operation. By opening the industry to a broader range of participants, S.530 could provide the financial services industry with much needed capital to meet higher capital standards and increased competitive pressures. Also, the industry will benefit as a result of increased managerial and technological resources and a link to the rigorous financial disciplines (e.g., strict cost control, product line profitability)

that are frequently practiced by manufacturing and commercial companies.

For example, at Ford we invested some $1 billion in First Nationwide and made available Ford expertise in management, cost controls and quality.

2. Remove anti-competitive barriers by providing equal treatment and powers. We need to expand the scope of activities in which an institution, or affiliates of that institution, can participate. The key to attracting new participants is a viable, healthy industry that offers investors the opportunity to earn a reasonable return. This, in turn, is dependent on the ability to adapt to changing market conditions and to compete effectively.

Depository institutions need not be prohibited from participating in securities underwriting and insurance operations through properly structured and regulated arrangements.

The relatively narrow, but significant restrictions of the Glass-Steagall Act were enacted out of the fear created by the Crash of 1929 and the Great Depression. In the meantime, the Securities Act of 1933, the Securities and Exchange Act of 1934, the Investment Company Act of 1940, the Investment Advisors Act of 1940, and the Federal Deposit Insurance Act of 1933 have been enacted. If affiliations between banks and securities firms were permitted today, they would be subject to a very different regulatory environment.

In addition, banks and thrifts should be allowed to diversify their financial services activities in order to reduce risk. Overly restrictive separations have had just the opposite effect -- discouraging diversification and increasing risk. Institutions have not failed because of new powers, but because of poor management, inadequate capitalization, inadequate supervision and a lack of diversification.

S.530 would allow institutions the opportunity to assess the market and participate in those areas which make the most sense based on customer needs, market characteristics, expertise, compatibility with other operations, and the existence of competitive opportunities (e.g., higher quality, better service, or lower cost). For example, Ford's growth in the financial services industry has focused on consumer lending and commercial leasing -- which provide a good fit with Ford's experience and strengths -- and not in businesses such as investment banking.

3. Provide functional regulation without regard to ownership, control or affiliations. We believe regulation is most effectively conducted by the agency with the greatest expertise. Consequently, regulation of banks and thrifts should remain with the appropriate bank and thrift regulators, regulation of insurance by the respective state insurance commissions, and securities with the Securities and Exchange Commission.

4. Provide enhanced safeguards to ensure the safety and soundness of the U.S. banking and deposit insurance systems. We support strong government regulation of depository institutions to protect the banking and deposit insurance systems. S.530 would provide this protection. It would apply strict application of meaningful capital standards; maintain firewalls to insulate the depository institution from non-banking affiliates; enhance regulation and supervision of the depository institution; and permit early intervention to protect the U.S. banking and the deposit insurance systems.

* * *

The time has come to modernize the structure of the U.S. financial system. As indicated, the present structure is outdated and inefficient for today's modern financial markets. In the absence of reform, U.S. financial institutions will find it increasingly difficult to serve the needs of their customers and compete in both U.S. and world markets.

S.530 provides a workable framework for modernization because it recognizes the interrelationships between the various factors and provides a comprehensive proposal for restructuring. It addresses the issue of competitiveness by eliminating both entry and anti-competitive barriers, while maintaining safety and soundness. It will allow firms to better serve their domestic customers and to prepare for international competition in an industry that is vital to the nation's future. In the early 1960s, the United States was the unquestioned leader in consumer electronics. This business has been all but lost to foreign competitors who were able to produce the products consumers wanted -- inexpensive, innovative, reliable, convenient and technologically advanced. The loss of this and other U.S. businesses should serve as a warning. If we and other U.S. providers do not meet rising customer expectations, financial services could be added to the list of industries the United States has pioneered and lost.

The Financial Services Council appreciates this opportunity to testify and it remains committed to working with this Committee as it continues its deliberations on these vital public policy issues.

APPENDIX 1

FINANCIAL
SERVICES
COUNCIL

MEMBERSHIP

The Acacia Group
51 Louisiana Avenue, N.W.
Washington, D.C. 20001

AmBase Corporation
59 Maiden Lane
New York, New York 10038

American Express Company
World Financial Center
American Express Tower
New York, New York 10285-5160

Bankers Trust New York Corp.
280 Park Avenue
New York, New York 10017

Beneficial Corporation
200 Beneficial Center
Peapack, New Jersey 07977

CalFed Inc.
5670 Wilshire Boulevard
Los Angeles, California 90036

Capital Holding Corporation
680 Fourth Avenue
Louisville, Kentucky 40202

Chemical Bank
277 Park Avenue
New York, New York 10172

Citicorp
399 Park Avenue
New York, New York 10043

Commercial Credit Company
300 St. Paul Place
Baltimore, Maryland 21202

Coverdell & Company
2622 Piedmont Road, N.E.
Atlanta, Georgia 30324

Dean Witter Financial Services Group Inc.
2 World Trade Center
New York, New York 10048

First Interstate Bancorp
707 Wilshire Boulevard
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Fleet/Norstar Financial Group, Inc.
50 Kennedy Plaza
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G. E. Financial Services
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Household International
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John Hancock Mutual Life
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J. P. Morgan & Co. Incorporated
23 Wall Street
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Kemper Financial Services, Inc.
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KeyCorp
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Meridian Bancorp, Inc.
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Merrill Lynch & Co., Inc.
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APPENDIX 2

S. 530
DEPOSITORY INSTITUTION AFFILIATION ACT

SUMMARY

The Depository Institution Affiliation Act ("DIAA") retains and reinforces the present legal framework of federal regulation and supervision of federally insured banks and thrifts while providing an alternative structure for permitting affiliations between banking institutions and nonbanking firms. The DIAA thus preserves all the safety-and-soundness and conflict-of-interest protections of the present system, while providing additional safeguards and the legal flexibility for a company to meet the financial needs of consumers, businesses and others by removing any limitations on affiliations.

This bill contains three titles:

TITLE I, which provides legal and supervisory framework to govern a new depository institution holding company ("DIHC");

TITLE II, which establishes a new National Financial Service Committee to monitor and facilitate future development of a modernized financial services regulatory structure; and

TITLE III, which amends existing provisions applicable to savings and loan holding companies in order to make acquisitions of insured savings institutions more attractive to companies outside that industry.

TITLE I: DEPOSITORY INSTITUTION HOLDING COMPANIES

A. Holding Company Options

No company should be forced to give up its present holding company structure and regulation. The DIAA thus provides an additional option.

- A company that controls an insured bank or thrift would have the option to become a Depository Institution Holding Company under the new DIAA framework or to operate under the present Bank Holding Company Act or Savings and Loan Holding Company Act.

B. Prior Review of Acquisitions

It is essential to prevent bad actors, undercapitalized companies or persons not properly qualified to manage a federally insured depository institution from taking control of one. The DIAA preserves all the present safeguards.

o The DIAA retains the present requirement that every person or company that seeks to take control of an insured bank or thrift must submit to prior review by that appropriate federal depository regulatory agency. That review ensures that the character, managerial capability and financial resources of an acquirer of an insured bank or thrift meet federal standards.

C. Functional Regulation

Functional regulation ensures that every regulated entity in a DIHC continues to be subject to regulation at least as stringent as at present and permits the holding company business flexibility to determine what lines of business to enter.

o Every insured bank and thrift would continue to be subject to all existing regulations and to examination and supervision by their present federal (and state) regulators. They would be required to maintain reserves, capital, liquidity, etc., as at present.

o Payment system activities would remain subject to exclusive Federal Reserve supervision.

o The DIHC would be subject to all applicable federal laws (*e.g.*, securities, antitrust), as well as the law of their state of incorporation.

o Nondepository DIHC subsidiaries would also continue to be subject to regulations as at present, *e.g.*, by the Securities and Exchange Commission, state insurance authorities, etc., as appropriate. The DIAA would require that DIHC subsidiaries engaged in insurance underwriting, securities dealing or underwriting, or real estate development be holding company subsidiaries, rather than depository institution subsidiaries, in order to ensure additional insulation of the bank or thrift.

D. Affiliate Transactions

Prevention of abuse of a federally insured institution by its affiliates is fundamental to a sound holding company structure. The DIHC retains and enhances the present safeguards against potentially abusive affiliate transactions. The DIAA would impose the present affiliate transaction restrictions contained in Sections 23A and 23B of the Federal Reserve Act and give the federal regulators additional regulatory authority to prevent affiliate transactions that might jeopardize the federal deposit insurance funds or undermine safety and soundness of a depository institution in a DIHC. The DIAA also imposes specific limitations on transactions between banks or thrifts and their securities affiliates. The DIAA thus provides both enhanced safeguards against improper affiliate transactions and regulatory flexibility.

o Section 23A restricts certain transactions between affiliates of a holding company limiting transactions such as loans or extensions of credit, investments, purchases of assets and financial guarantees to no more than 10 percent of the capital and surplus of the bank for a single affiliate and 20 percent for all affiliates. Also bank loans, guarantees and letters of credit on behalf of an affiliate are subject to strict collateral requirements (between 100 and 130 percent) and the purchase by the bank of low quality assets from an affiliate is prohibited.

o Section 23B requires that a bank may engage in certain transactions with an affiliate only if the terms, including credit standards, are at least as favorable to the bank as those prevailing for comparable transactions with unaffiliated companies. A bank and its affiliates are prohibited from indicating that the bank is responsible for its affiliate's obligations. Also, a bank is prohibited from purchasing as a fiduciary any securities or assets from any affiliate. No bank, while acting as a principal or fiduciary, may knowingly purchase or acquire any security for which an affiliate is a principal underwriter until after the underwriting syndicate has been dissolved, unless a majority of the outside directors approve.

o The DIAA would further prohibit all depository institutions controlled by a DIHC in the aggregate from entering into transactions with non-insured affiliates where any or all such transactions would exceed two percent of the capital stock and surplus of the combined depository institutions and no individual depository institution controlled by a DIHC could enter into such transactions when they would exceed one half of one percent of the capital stock and surplus of the depository institution.

- The DIAA would authorize the primary federal regulators of depository institutions controlled by DIHCs to promulgate additional rules to prevent depository institutions under their supervision from engaging in transactions that would compromise the safety and soundness of such institutions or that would jeopardize the integrity of the deposit insurance funds.

- The DIAA would prohibit any depository institution in a DIHC from extending credit to a securities affiliate or its subsidiary, purchasing for its own account assets of a securities affiliate or its subsidiary, issuing a guarantee, acceptance or letter of credit for the benefit of a securities affiliate or its subsidiary, and extending credit to an investment company advised by or the shares of which are distributed by a securities affiliate.

- The DIAA would prohibit DIHCs from engaging in certain activities with the purpose of enhancing the marketability of a securities issue underwritten or distributed by a securities affiliate.

E. Divestiture

The ultimate safeguard of the integrity of an insured depository institution and the federal insurance funds is the ability of the federal regulators to require divestiture of the institution while it is still in relatively sound condition. The DIAA adds two new safeguards.

- The DIAA would require divestiture of the depository institution if minimum levels of required capital are not maintained.

- The DIAA would authorize the primary federal regulators of a depository institutions controlled by a DIHC to require a DIHC to divest a depository institution if the regulator finds that a depository institution is engaged in a continuing course of conduct involving a DIHC or any of its affiliates that would endanger the safety and soundness of the depository institution. Specifically, the DIAA provides these regulators with the discretion to require bank and thrift subsidiaries of a DIHC to maintain capital of up to 3% of assets in addition to the minimum capital required of similar institutions not in a DIHC.

F. Enforcement

Short of divestiture, federal depository institution regulators must have the panoply of enforcement tools. The DIAA retains all present enforcement authority and options, but would authorize an important additional one -- the ability of the regulators to go directly to court for an injunction without first having to initiate an administrative cease-and-desist procedure. The DIAA would also provide for very high money penalties on companies or individuals that violate the DIAA.

- The appropriate federal regulator of the depository institutions controlled by a DIHC could use its full examination and supervisory powers, including its cease and desist powers, to enforce the provisions of the Act. The regulator could also examine any affiliate of a depository institution to insure compliance with the Act or Sections 23A and 23B of the Federal Reserve Act.

- The DIAA expressly restricts a DIHC or any uninsured affiliate from benefitting from the deposit insurance available to an insured bank or thrift.

- State or Federal regulators of any affiliate of a DIHC must promptly notify the appropriate federal regulator of the insured depository institution if it suspects a violation of the DIAA.

- The Act would grant the federal regulators the right to seek an injunction or temporary restraining order against any person or company from the appropriate district court whenever the regulator considers that any insured depository institution or DIHC is violating, has violated, or is about to violate any provision of or any regulation under the Act. Equitable relief including divestiture may be requested from the court.

- Federal regulators would be empowered to impose civil penalties for violations of the DIAA by a DIHC or its bank or nonbank affiliates. These penalties would be a fine of not more than the greater of $250,000, per day, per violation, or up to a maximum 1% of the minimum required capital level of the DIHC's bank or institution. For individuals, the maximum penalty may be up to $250,000 or twice the person's annual compensation and/or one year imprisonment. (Under present law, the maximum per violation per day fine is $10,000.)

- Willful violations of the DIAA would be punishable by criminal penalties in the same amounts as the civil money penalties. In addition, individuals could be sentenced to up to one year in prison.

G. Securities Insurance and Real Estate Activities.

The DIAA would require a DIHC to shift most securities, insurance underwriting and real estate activities from its bank or thrift subsidiaries to holding company affiliates. If the DIHC has not previously engaged in insurance or real estate agency activities, it may do so only through acquisition of an existing insurance or real estate agency. The acquired insurance agency or real estate brokerage firm may be legally affiliated with a depository institution controlled by a DIHC under the laws of the state where the DIHC controls the depository institution and in the state where the acquired insurance agency or real estate brokerage firm is chartered or licensed. The DIAA does not preclude the acquired insurance agency or real estate brokerage firm from engaging in insurance or real estate activities in states other than those just mentioned, to the extent those activities are permissible in those other states.

H. Antitying.

A DIHC would be subject to the special antitying provisions now applicable to bank holding companies. These provisions prohibit a bank from requiring any customer to accept any nonbanking product or service in conjunction with any banking product or service.

I. Insider Lending.

Executive offices and directors of a DIHC and its subsidiaries would be subject to the restrictions on insider lending under Section 22(h) of the Federal Reserve Act, including its prohibitions on extensions of credit from a depository institution subsidiary of the DIHC on preferential terms.

J. Interstate Expansion.

The DIAA does not modify present law on interstate expansion and would permit a DIHC to acquire additional banks or thrifts only in states in which a bank holding company or savings and loan holding company with the same home state could make an acquisition.

K. Registration of Brokers and Dealers.

Brokers or dealers would not be granted registration by the Securities and Exchange Commission unless they met all requirements established by this Act, including capital adequacy requirements.

L. Glass-Steagall Act.

The DIAA would exclude DIHC's from the affiliation restrictions of Sections 20 and 32 of the Glass-Steagall Act.

M. Discrimination Under State Law.

The DIAA would prohibit a state from imposing restrictions on affiliations or discriminatory provisions applicable to DIHC's and thus defeat the purposes of the DIAA. Legitimate, non-discriminatory state business regulation would not be affected.

TITLE II -- NATIONAL FINANCIAL SERVICES COMMITTEE

Title II would create a National Financial Services Committee (the "Committee") to provide a forum in which regulators could reach a consensus regarding the evolution of depository institution regulation in view of changing market conditions. It would provide general oversight and coordination of the implementation of functional regulation.

o The members of the Committee would be the heads of the financial regulatory agencies (Federal Reserve, FDIC, Comptroller of the Currency, Federal Home Loan Bank Board, SEC, Commodities Future Trading Commission) plus the Attorney General and Secretary of Commerce.

o The Committee would make recommendations to Congress to strengthen the insulation between insured banks and insured institutions controlled by DIHCs and their affiliates.

o The Committee would hold public meetings at least annually, to which state regulators would be invited.

o The Committee could conduct or authorize studies to carry out the purposes of the Act and based on such studies could recommend changes in financial regulation needed to carry out the purposes of the Act.

o The Treasury Department would provide staff for the Committee and assume any expenses connected with the work of the Committee.

TITLE III -- THRIFT ENHANCEMENT

In order to help attract much needed capital into the thrift industry and bolster the condition of the FSLIC, the Act would enhance the value of the thrift franchise by removing a number of outmoded or onerous restrictions on thrifts and their parent holding companies.

A. Affiliate Transactions.

The Act would subject unitary savings and loan holding companies' insured institution subsidiaries which meet the qualified thrift lender test to the restrictions on affiliate transactions applicable to all insured banks, including the provisions of Sections 23A and 23B of the Federal Reserve Act. The FSLIC would administer Sections 23A and 23B as it applies to thrifts and would have rulemaking power similar to the power the Federal Reserve Board has with respect to member banks. In addition, the Act extends certain provisions of Sections 22(g) and (h) of the Federal Reserve Act, concerning extensions of credit to executive officers and directors of thrifts and their holding companies.

B. Debt Approval Requirement.

The Act would exclude savings and loan holding companies and their subsidiaries from debt approval requirements if each of their thrift subsidiaries have met the qualified thrift lender requirement for two of the three preceding fiscal quarters.

C. Management Interlocks.

The Act would remove a redundant Savings and Loan Holding Company Act management interlock restriction. The Act also would amend the Depository Institutions Management Interlocks Act to permit management interlocks between savings and loan holding companies whose insured institution subsidiaries meet the qualified thrift lender requirement and non-affiliated depository institutions or holding companies, unless the FHLBB determines that such an interlock would result in a monopoly or tend to lessen competition, and the FHLBB further determines that prohibiting the interlock is the only way to prevent these anti-competitive effects.

D. Glass-Steagall.

The Act would exempt savings and loan holding companies, each of whose insured institution subsidiaries meets the qualified thrift lender requirement, from restrictions contained in Section 408(r) of the National Housing Act on affiliations with institutions engaged in underwriting and distributing securities, which is scheduled to expire on March 1, 1988, in any case.

E. Cross-Marketing.

The Act would exempt savings and loan holding companies, each of whose insured institution subsidiaries meets the qualified thrift lender requirement, from restrictions on cross-marketing contained in Section 408(p) of the National Housing Act.

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The CHAIRMAN. Very good. Thank you, Mr. Whipple, for a tight and focused presentation. We appreciate having that view.

Mr. Vallandingham, we are pleased to have you here representing the Independent Bankers Association of America. I know as well you're the president of a bank in Barboursville, West Virginia and we are pleased to have you here.

STATEMENT OF PHILIP VALLANDINGHAM, PRESIDENT, INDEPENDENT BANKERS ASSOCIATION OF AMERICA; AND PRESIDENT, THE FIRST STATE BANK OF BARBOURSVILLE, BARBOURSVILLE, WV

Mr. VALLANDINGHAM. Thank you, Mr. Chairman.

As you stated, I am Phil Vallandingham and I'm president of the First State Bank of Barboursville, WV; as well as president of the Independent Bankers Association of America.

My testimony outlines a few of the recommendations of IBAA and our reactions to other proposals. IBAA's committees have been studying these issues in depth. We recently proposed legislation, The Consumer Financial Services Act, that would allow 95 percent of the banks 100 percent of the services and products they wish to offer their customers. Just last month we submitted our comments to the Treasury Department for its consideration in its study of the deposit insurance issue. We would like to submit a copy of that set of comments to this committee to be placed in the record of this hearing.

The CHAIRMAN. Thank you. We will make them a part of the record.

Mr. VALLANDINGHAM. Thank you.

First, it is our contention that the deposit insurance system is no longer fair. Under the Government's unwritten too-big-to-fail policy, all deposits in the largest banks, including foreign deposits and nondeposit liabilities, have complete coverage. Community banks can offer coverage only up to the statutory limit of $100,000. At the same time, banks under $100 million in assets, some 10,500 institutions, fund over 88 percent of those assets with deposits subject to insurance assessment. In contrast, banks over $30 billion in assets, 11 banks which are clearly considered too big to fail, fund only 38 percent of their assets with assessable deposits.

We have endorsed the policy of equal treatment for all depositors at all banks, regardless of size. The American farmer or the small businessperson is entitled to the same deposit insurance coverage at home as the wealthy oil merchant has in the London branch of Citicorp.

Community banks should be extended the same 100 percent protection enjoyed by major banks in the context of a broader assessment base, but only so long as depositors at our Nation's largest financial institutions are not at risk. IBAA supports a "sunset" provision terminating the 100 percent coverage when such coverage has been terminated for depositors at large financial institutions.

Second, the IBAA shares the conclusion that neither this government nor any future Government will permit a very large bank to fail. The effect such a decision could have on the confidence in the

United States and the world banking systems could be catastrophic.

Third, the FDIC fund apparently lost reserves in 1989 and could face additional pressure in 1990. In the context of the upcoming budget considerations, isn't this the time to broaden the assessment base in the interests of fairness and to raise substantial new revenues for the FDIC?

Foreign deposits and nondeposit liabilities enjoy *de facto* deposit insurance coverage and it is patently unfair that these deposits are not assessed. Assessing them would bring significant income to the insurance fund, as much as $900 million in 1991 alone.

Fourth, with regard to alternatives to the Federal deposit insurance, some say that when a bank fails all depositors should be given a "haircut"; that is, forced to take a loss on their uninsured deposits. We are skeptical that this scheme could be implemented without creating financial instabilities and there could be severe international ramifications. Several high Government officials have said that the U.S. banks would be at a disadvantage in comparison to their foreign competitors if we unilaterally eliminated the too-big-to-fail doctrine.

Fifth, in the case of community banks which would offer traditional banking services together with insurance, securities and real estate sales, functional regulation raises some concerns.

Should a bank holding company structure with all the subsidiaries be created, we believe some governmental oversight of the entire enterprise would be essential.

Sixth, in examining the regulatory structure and its functions, we believe it is critical to recognize that excessive and unnecessary paperwork and compliance requirements are imposing such a severe burden on community banks that it threatens their very survival. The IBAA opposes legislation such as the Metzenbaum bill mandating Government check cashing and lifeline services which would increase the overall compliance and paperwork burden of community banks while decreasing services and/or increasing the costs for the consumer.

Seventh, deregulation is still a solution in search of a problem. It has been for 10 years. It is now touted as a way to help our major international banks, about ten of them, compete overseas. We still oppose deregulation proposals such as the repeal of the Glass-Steagall Act or even more drastic financial restructuring proposals like H.R. 1992. We will vigorously oppose these proposals which violate the separation of banking and commerce. We prefer an incremental approach to granting banks additional powers. Deregulation benefits only a handful of American banks. According to Federal Reserve Chairman Greenspan, "international banking is and has been concentrated in a small number of U.S. banks. Four out of the 10,000 U.S. banking organizations account for roughly one-half of the international assets; 10 of those account for a little over 80 percent."

Finally, we would note with interest the recent suggestion of Comptroller General Bowsher that a two-tiered system may be appropriate. "We believe it is appropriate to consider changing the way big banks are regulated and insured. In return for certain special protections, higher premiums or premiums on all deposits may be necessary." We feel that further study of an expanded version of this concept is warranted. It could tie the undertaking of risky new activities which increase U.S. Government exposure to curtailments of safety net protections, including deposit insurance. Let those who want to engage in new risky activities face higher premiums or coverage adjustments.

In conclusion, Mr. Chairman, the IBAA shares your vision of an America competitive at home and abroad. We believe we have set forth recommendations that can help assure us of attaining that goal. We recognize that there are many competing interests and different ideas on how to approach the future for the financial services industry. We therefore pledge to work with the Congress and the administration in attempting to devise a plan which will set the stage for competing in the world marketplace, while maintaining a strong, diverse and fair system of community banking for Main Street America.

We thank you for the opportunity to testify.

[The complete prepared statement of Philip Vallandingham follows:]

TESTIMONY

OF

PHILIP VALLANDINGHAM
PRESIDENT
INDEPENDENT BANKERS ASSOCIATION OF AMERICA

AND

THE FIRST STATE BANK OF BARBOURSVILLE
BARBOURSVILLE, WEST VIRGINIA

BEFORE THE

COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS
UNITED STATES SENATE
WASHINGTON, D.C. 20510

APRIL 24, 1990

SUMMARY OF TESTIMONY OF
PHILIP VALLANDINGHAM
INDEPENDENT BANKERS ASSOCIATION OF AMERICA

FEDERAL DEPOSIT INSURANCE REFORM

First, the deposit insurance system is no longer fair, and that makes it harder for local banks and their communities to compete. Under the government's unwritten too-big-to-fail policy all deposits in the largest banks, including foreign deposits and non-deposit liabilities, have complete coverage. Community banks can offer coverage only up to the statutory limit of $100,000. At the same time, banks under $100 million in assets (some 10,500 institutions) fund over 88 percent of those assets with deposits subject to insurance assessments. In contrast, banks with more than $30 billion in assets (11 banks which are clearly considered too-big-to-fail) fund only 38 percent of their assets with assessable deposits.

We have endorsed the policy of equal treatment for all depositors at banks, regardless of size. The American farmer or small businessperson is entitled to have the same deposit insurance coverage at home as the wealthy oil merchant has in the London branch of Citicorp.

Community banks should be extended the same 100 percent protection enjoyed by major banks in the context of a broader assessment base, but only so long as depositors at our nation's largest financial institutions are not at risk. The IBAA supports a "sunset" provision terminating the 100 percent coverage when such coverage has been terminated for depositors at large financial institutions by administrative and/or Congressional action.

The IBAA shares the conclusion that neither this government nor any future government will permit a very large bank to fail. The effect such a decision could have on the confidence in the U.S. and world banking systems could be catastrophic and should not be risked. It is ironic, therefore, that in the midst of the latest government "bailout"--the Bank of New England--the top regulators of our government and the money center banks are promoting a new mythology that depositors at the nation's largest banks must be at risk--a policy that would create future financial instability and decrease international competitiveness.

Second, the FDIC fund apparently lost reserves in 1989 and could face additional pressure in 1990. In the context of the upcoming budget considerations, isn't this the time to broaden the assessment base in the interests of fairness and to raise substantial new revenues for the FDIC?

Foreign deposits enjoy *de facto* deposit insurance coverage and it is patently unfair that these deposits are not assessed. Assessing foreign deposits would bring significant income to the insurance fund. By 1991, if foreign deposits were assessed at the increased premium rate, the yield to the FDIC fund would be almost $500 million annually.

We also recommend that non-deposit liabilities, such as collateralized borrowings and other "deposit notes," should be added to the insurance base, since these instruments represent a liability to the insurance fund. The 30 largest commercial banks in the U.S. alone could add over $20 billion in assessment income to the BIF (at the 1990 rate of .12) if non-deposit liabilities were assessed.

We strongly believe that adequate capital is the cornerstone to the safety and soundness of our financial system and to the insurance fund. IBAA believes that an insured financial system requires a higher minimum leverage ratio than is presently being considered by the OCC and FRB. A more adequate minimum leverage ratio would be more than 4 percent Tier 1 capital.

IBAA strongly supported the provision in FIRREA that prevents undercapitalized institutions from using brokered deposits. This provision has gone a long way towards correcting the abuses of brokered deposits by institutions that paid above-market rates and used this "hot money" to fund risky loans.

And while some say that when a bank fails, all deposits should be given a "haircut"--i.e., forced to take a loss on their uninsured deposits--we are skeptical that this scheme could be implemented without adding to financial instability. And, there could be severe international ramifications. Several high government officials have not only questioned whether such a system was feasible, but have also said that U.S. banks would be at a disadvantage in comparison to their foreign competitors if we unilaterally eliminated the too-big-to-fail doctrine.

SHOULD THE CURRENT REGULATORY STRUCTURE BE IMPROVED?

Functional regulation may make sense in the case of a major holding company that combines a series of large companies in different lines of business. In the case of smaller players, like community banks which would offer traditional banking service together with insurance, securities, and real estate sales, functional regulation raises some concerns.

Regarding the issue of whether one government agency should be given regulatory authority over the holding company, we believe that some governmental oversight of the entire enterprise would be essential to protect the wide range of interests involved in a broad-based firm.

In examining the regulatory structure and its functions, we believe it is critical to recognize that excessive and unnecessary paperwork and compliance requirements are imposing such a severe burden on community banks that it threatens their very survival.

The IBAA opposes consumer legislation, such as the Metzenbaum bills mandating government check cashing and lifeline services, which would increase the overall compliance and paperwork burden of community banks while decreasing service and/or increasing costs for the consumers.

DEREGULATION

Deregulation is still a solution in search of a problem, as it has been for ten years. It is now touted as a way to help our major international banks--about 10--compete overseas.

We still oppose a radical deregulation proposals, such as the repeal of the Glass-Steagall Act, or even more drastic financial "restructuring" proposals like H.R. 1991. We will vigorously oppose any proposal which violates the separation of banking and commerce. We prefer an incremental approach to granting banks additional powers. Deregulation benefits only a handful of American banks, and few American consumers, while increasing instability for the financial system. According to Fed Chairman Greenspan, "International banking is and has been concentrated in a small number of U.S. banks. Four out of the 10,000 U.S. banking organizations account for roughly half of international assets; 10 of those account for a little over 80 percent."

Last year the IBAA proposed the Consumer Financial Services Act. Its purpose is to permit banking organizations to offer a full range of retail financial services to their customers. And, because it does not grant new underwriting power, except in one narrow instance, our bill does not threaten the stability of the system as do more radical proposals.

Finally, we noted with interest the suggestion of Comptroller General Charles Bowsher, when testifying on February 21,1990 before the House Banking Committee, that a two-tier system may be appropriate: "We believe it is appropriate to consider changing the way big banks are regulated and insured. In return for certain special protections, higher premiums or premiums on all deposits may be necessary." In this statement, Mr. Bowsher was referring to the too-big-to-fail policy. We feel that further study of an expanded version of this concept is warranted. It could tie the undertaking of risky new activities which increase the U.S. Government exposure to curtailments of safety net protections, including deposit insurance. Let those who want to engage in new risky activities face higher premiums or coverage adjustments.

Mr. Chairman and members of the Committee, I am Philip Vallandingham, President of the First State Bank of Barboursville, West Virginia. I am appearing before you this morning in my capacity as President of the Independent Bankers Association of America (IBAA). The IBAA is the only national trade association that exclusively represents the interests of our nation's community banks.

I appreciate the opportunity to testify before the Committee regarding the need for legislation to modernize the regulation of financial services. In your letter of invitation, you asked that our testimony focus specifically on three issues: 1.) Federal deposit insurance reform; 2.) how to improve the current regulatory structure; and 3.) whether new powers should be granted to banks or their affiliates.

As often as all of us--the Committee, the Congress, the various administrations, and the interested industry and public organizations--have discussed these issues, they have never had quite the urgency that they appear to have now. This series of hearings could help lay the foundation for landmark legislation within the next year or two. It is of the utmost importance, therefore, that this foundation include building blocks that, while possibly attempting to enhance the international competitive position of a handful of our largest banks, will not sacrifice the needs of the millions of American consumers who simply want good service from their friendly local banker. Most importantly, it is our view that safety and soundness considerations must take precedent over further sweeping deregulation which would weaken the safety net.

In my testimony this morning, I will outline the recommendations of the IBAA on how to form these building blocks, as well as some of our reactions to other proposals. IBAA's committees have been studying these issues in depth. We recently proposed legislation--the Consumer Financial Services Act--that would allow 95 percent of the banks 100 percent of the services and products they wish to offer to their customers. And just last month, we submitted our comments to the Treasury Department for its consideration in its study of the deposit insurance issue. I would like to submit a copy of those comments to the Committee to be placed into the record of this hearing.

FEDERAL DEPOSIT INSURANCE REFORM

Federal deposit insurance is vital to consumers, businesses, farmers, and ranchers in communities throughout the country. From its establishment during the days of financial crisis in the 1930s, deposit insurance has become an integral component of our financial system. Without it our financial system would not function efficiently and consumer confidence would be seriously weakened. Consumers count on it to protect the money they use every day, whether for their savings or for their retirement. The goals of deposit insurance remain unchanged--to protect the deposits of consumers and small business, which ultimately makes it possible for local banks and other financial institutions to lend money into the local economy to help it prosper and grow.

In the last few years, however, that public confidence has been shaken. The demise of an important segment of the savings and loan industry and the failure of its insurance fund, authoritative statements that the Bank Insurance Fund suffered another loss in 1989, and the perception by the consumer that a dual system of deposit insurance coverage exists in our nation--one for depositors in large banks and another for those in small banks--have all contributed to this crisis of confidence.

The proposals we are recommending, which would point the way toward making the deposit insurance system stronger and more equitable, and to regaining the confidence of the American depositor in our financial system, are as follows: 1.) provide equality of deposit insurance coverage to banks of all sizes; 2.) equalize and broaden the insurance base; 3.) increase capital requirements; 4.) ensure effective supervision and regulation; and, 5.) place limits on brokered deposits.

Equality of Deposit Insurance Coverage

The deposit insurance system is no longer fair, and that makes it harder for local banks and their communities to compete. Under the government's unwritten too-big-to-fail policy, all deposits in the largest banks, including foreign deposits and non-deposit liabilities, have complete coverage. Community banks can offer coverage only up to the statutory limit of $100,000. At the same time, banks under $100 million in assets (some 10,500 institutions) fund more than 88 percent of those assets with deposits subject to insurance assessments. In contrast, banks with more than $30 billion in assets (11 banks which are clearly considered too-big-to-fail) fund only 38 percent of their assets with assessable deposits.

We have endorsed the policy of equal treatment for all depositors at all banks, regardless of size, and have strongly urged that the FDIC assessment base be broadened to cover foreign deposits and other non-deposit liabilities. Equity demands that the American farmer or small businessperson have the same deposit insurance coverage at home as the wealthy oil merchant has in the London branch of Citicorp.

In his call for equitable treatment, Senate Minority Leader Bob Dole stated in the March 9 Congressional Record:

> In recent years, however, Federal banking regulators have distorted the original purpose of the insurance fund. They have made the insurance fund "regressive" by institutionalizing something called the "too big too fail" doctrine, which is nothing more than a shorthand way of saying that "the big banks"--and those depositors in the big banks--get preferential treatment when it comes

> to deposit insurance protections.
>
> This preferential treatment artificially hinders the ability of small banks to attract depositors. It makes small banks less competitive. And it is particularly unfair, since it is the large banks--not small banks--who pose the greatest risks to the overall Federal Deposit Insurance System.
>
> ...Don't get me wrong...There are obviously legitimate policy reasons for ensuring that the very largest financial institutions in this country remain on solid footing.
>
> But favorable treatment for the big banks should not mean unequal treatment for our nation's smaller banks. The small banks of this country...should receive the same treatment as the large money-center banks when it comes to enjoying the full protections of the Federal Deposit Insurance System. And depositors in small banks should face the same risks--not greater risks--than their counterparts in the big banks.
>
> ...Equal treatment and equal risk under the Federal Deposit Insurance System--that should be the doctrine guiding our federal banking regulators.

Community banks should be extended the same 100 percent protection enjoyed by major banks in the context of a broader assessment base, but only so long as depositors at our nation's largest financial institutions are not at risk. The IBAA supports a "sunset" provision terminating the 100 percent coverage when such coverage has been terminated for depositors at large financial institutions by administrative and/or congressional action.

We commit to working with the Congress, the Administration, and the regulatory agencies to secure the passage of legislation and enactment of regulations which ensure that depositors at failing large banks are put at risk like our depositors over the $100,000-level level are presently at risk. The stakes are too high to accept declarations, which can be self-serving, that no big bank is too big to fail.

Acknowledge Too-Big-To-Fail Policy

Regulators in the United States--as well as in other industrialized nations--are following an unwritten policy that their largest banks are too big to fail. This policy accords deposits at such institutions 100 percent coverage.

This is a clear transformation and extension of the original role of deposit insurance as a safety net for small depositors. This policy of extending 100 percent deposit insurance coverage to virtually all depositors in very large institutions was made explicit when the Continental Illinois National Bank and Trust Company failed in 1984 and all deposits--including foreign deposits and deposits of more than $100,000--were protected. The rationale for this action was publicly expressed by then-Comptroller of the Currency D. Todd Conover, when he told members of the House Banking Committee that:

> ...had Continental failed and been treated in a way in which depositors and creditors were not made whole, we could very well have seen a national crisis the dimensions of which were difficult to imagine.

In 1988, when First RepublicBank in Texas failed, it was assured by the FDIC that all of its depositors--both insured and uninsured--would be given full deposit insurance protection.

Most recently, the Bank of New England has been the recipient of special government largesse. And following severe declines in the stock market in 1987 and again in 1989, the Federal Reserve Board extended the government hand to the securities industry.

This policy of total protection for the depositors of large banks, which has consistently been followed by our regulators since the end of World War II, has not trickled down to depositors at small, failing banks, a fact which has been publicly stated on several occasions, including by FDIC Chairman L. William Seidman in testimony before the House Banking Committee on September 19, 1989:

> ...The problem that you have to face is that at least in the past we have always had to protect depositors of very large banks to defend the integrity of the system. If in fact that is what has to be done, that is where your major deposit insurance costs are, and you get discrimination against smaller banks if you intend to say that their depositors will be protected in a different way.

And speaking before a conference organized by the Association of Reserve City Bankers on December 14, 1988, FDIC Chairman Seidman, in answering his own rhetorical question of "Why don't we experiment and allow the next $30 billion bank that fails to close and see what happens?" said:

> So far the bureaucrat with that kind of courage hasn't been born, and I don't think he will be born. So that's not going to happen with a major institution. Given that, what are you going to do about smaller institutions. Are you going to tell them, oh, your depositors are going to lose, but the big guy, no, they'll always be protected.

The IBAA shares the conclusion that neither this government nor any future government will permit a very large bank to fail. The effect such a decision could have on the confidence in the U.S. and world banking systems could be catastrophic and should not be risked. It is ironic, therefore, that in the midst of the latest government "bailout"--the Bank of New England--the top regulators of our government and the money center banks are promoting a new mythology that depositors at the nation's largest banks must be at risk. While attempting to promote the international competitiveness of U.S. banks by granting new powers, they are considering a policy that would create future financial instability and decrease international competitiveness. FDIC Chairman Seidman has hinted at possible international negotiations aimed at having all major industrial countries agree that their banks are not too-big-to-fail. It is our understanding that no systematic U.S. government effort towards this end is underway.

Policymakers should instead provide for equal protection for _all_ depositors at _all_ institutions _at comparable rates_ when considering deposit insurance reform. Large institutions, which present a systemic risk to the insurance system, clearly enjoy 100 percent coverage. Equity demands that depositors at small institutions, which present no such systemic risk to the system, also enjoy 100 percent protection.

Equalize and Broaden the Insurance Base

The FDIC fund apparently lost reserves in 1989 and could face additional pressure in 1990. In the context of the upcoming budget considerations, isn't this the time to broaden the assessment base in the interests of fairness and to raise substantial new revenues for the FDIC?

Assess Foreign Deposits

Foreign deposits enjoy _de facto_ deposit insurance coverage and it is patently unfair that these deposits are not assessed. IBAA believes that assessing foreign deposits is not only feasible, it would also bring significant income to the insurance fund.

A foreign deposit is a deposit held in a foreign branch of a domestic bank. Many of the money center banks have opened branch offices in foreign countries and actively engage in deposit-gathering activities. Deposits held in branches located in foreign countries are not assessed FDIC insurance premiums and are not subject to the Federal Reserve's reserve requirements.

Foreign deposits may be in any amount and may be owned by anyone, including Americans. It is not unusual for a large U.S. company to deposit funds in a foreign branch of its U.S. bank in order to earn a higher return on its deposits. The higher return is possible due to the foreign branch's lower cost of funds.

As of September 30, 1989, foreign deposits totalled $331 billion. Assessing these deposits at the current premium of 12 cents per $100 would result in annual revenue to the BIF of nearly $400 million. By 1991, banks' insurance premiums will increase by almost 80 percent to 15 cents per $100. If foreign deposits remained stagnant at $331 billion and were assessed at the increased premium rate, the yield to the FDIC fund would be almost $500 million annually (see Table 3). The banks that hold the largest percentage of the foreign deposits have an obvious bottom-line interest to ensure that these deposits are not included in the assessment base (see Table 4).

Money center banks have claimed that the deposits gathered at foreign branches do not fund their consolidated operations. The facts do not support this statement.

As of December 31, 1988, 254 U.S. banks held deposits gathered from their foreign branches. There are approximately 743 foreign branch offices; the five largest U.S. banks account for 464 of those offices. Current FDIC reports show that the top 25 banks held approximately 85 percent of the foreign deposits, while the top five banks held 50 percent of the total foreign deposits. For each of the top five banks, foreign deposits contributed significantly to the banks total deposits. For example, as of September 30, 1989, foreign deposits as a percentage of total deposits equaled 60 percent at Citibank, 81 percent at Morgan Guaranty, 54 percent at Chase Manhattan, 59 percent at Bankers Trust and 45 percent at Manufacturers Hanover (see Table 4). It is difficult to accept the proposition that deposits which contribute approximately 50 percent of a bank's total deposits are not being utilized to fund consolidated operations.

Foreign deposits provide larger banks with a less expensive funding source when compared to the costs of utilizing domestic deposits. To illustrate this savings, note that Citibank recently paid $46 million in FDIC premiums at the then current rate of 8.3 cents per $100. If Citibank's foreign deposits had been assessed, this would have translated into an additional $49 million annually.

A study prepared for the U.S. Banker by Olson Research Associates in April 1989 showed that the proposed higher FDIC premiums of 15 cents per $100 will reduce the net income of most banks by 3 or 4 percent. The reduction in earnings for the largest banks, however, will be significantly less than for the average bank. Because foreign deposits are not assessed, the study indicates that the reduction in income for the largest users of foreign deposits will be only approximately one percent.

Another argument commonly used against assessing foreign deposits is that U.S. banks will transfer deposits from the foreign branch into a foreign subsidiary of the bank. This argument overlooks the fact that the ability of U.S. banks to operate wholly-owned foreign subsidiaries is completely dependent upon the laws of the host country, not the laws of the United States. Many foreign governments require U.S. banks to operate through local branches. Several U.S. Circuit Court cases have recognized that U.S. banks may not be permitted to establish a wholly-owned bank subsidiary as a result of the host country's laws. If foreign deposits were assessed, U.S. banks would have to consider the requirements of the laws of the host countries where their branches are located prior to transferring any funds.

One of the most serious arguments that has been offered against the assessment of foreign deposits is that it would dilute the BIF by forcing it to cover these deposits. It is our view that the BIF is already diluted because foreign deposits enjoy de facto coverage and the situation will not be corrected unless those deposits are assessed.

Extending deposit insurance coverage to foreign deposits will bring significant income to the BIF and improve its ability to meet all of its responsibilities.

Assess Non-Deposit Liabilities

We recommend that non-deposit liabilities, such as collateralized borrowings and other "deposit notes," should be added to the insurance base. The IBAA has long advocated the assessment by the FDIC of non-deposit liabilities, since these instruments represent a liability to the insurance fund.

The level of domestic deposits in large institutions is not a true reflection of their total assets, and it is assets that generate risk. For instance, non-deposit liabilities fund one-fifth of the total assets of both Chemical Bank and Security Pacific National Bank (see Table 4). The vast majority of non-deposit liabilities are held by large institutions. These large institutions are increasingly using deposit notes and other deposit-like instruments to avoid deposit insurance assessments. Because these institutions fall under the FDIC's too-big-to-fail policy, these non-deposit liabilities have de facto coverage by the insurance fund, although the banks are not assessed insurance premiums.

The 30 largest commercial banks in the U.S., all of which have more than $12 billion in assets, held a total of more than $182 billion of non-deposit liabilities as of September 30, 1989 (See Table 5). Non-deposit liabilities represent almost 17 percent of the total assets of these institutions. The BIF could receive over $20 billion in assessment income (at the 1990 rate of 0.12) from these 30 institutions alone if non-deposit liabilities were assessed.

Institutions such as community banks, which rarely use collateralized borrowings, deposit notes and other non-deposit liabilities, bear a disproportionate share of insurance fund assessments. The IBAA strongly recommends that the FDIC assessment of collateralized borrowings, deposit notes and other non-deposit liabilities as a step toward both a more equitable assessment base and the strengthening of the insurance fund.

Broadening the Base

Our previous comments recognize that all the liabilities of major banks, including non-deposit liabilities and foreign deposits, are now contingent liabilities of the Bank Insurance Fund. We also recommend that all banks be granted the same insurance coverage enjoyed by the too-big-to-fail banks. This requires that all of the industry's liabilities be assessed. In addition, it requires that the BIF's reserve level be measured against this larger base.

In the past, the adequacy of the insurance fund has been measured against the amount of insured deposits in the banking system, excluding domestic deposits over $100,000, non-deposit liabilities, and all foreign deposits. However, because the bulk of these technically uninsured liabilities are in too-big-to-fail banks, they are de facto contingent BIF liabilities, even under current law and practice. Therefore, we recommend the statutory change necessary to include non-deposit liabilities and foreign deposits in the base against which the insurance fund is measured.

The following table sets forth key features of the current system and our base-broadening recommendation:

Current System

Base:	Insured deposits
Required reserve level:	1.25%
Year level is reached:	1993
Amount in fund in 1993: (See Table 1)	$29 billion

Base-Broadening Recommendation

Base:	All domestic deposits, all foreign deposits, non-deposit liabilities
Required reserve level:	1.25%
Year level is reached:	1996
Amount in fund in 1996: (See Table 2)	$56 billion (equals 1.4% of base)

The base-broadening that we recommend would delay reaching the new recommended target reserve level by three years, under current projections. However, it would recognize the BIF's broader responsibilities, permit full coverage for all institutions, and provide the taxpayers with a substantial assurance that they will not be called upon to pay for losses incurred by commercial banks.

However, it is critical that this larger fund not be used to pay for losses in the savings and loan industry. This would be unfair, and it would be unwise to tap these funds which may be needed to preserve the future stability of the nation's financial system.

We also recommend that the BIF not be included in the federal budget. As long as it is included in the budget there is a greater temptation to use BIF income to offset other spending. But the fund has critical functions which are not subject to traditional budget discipline. When the FDIC must spend money from this fund its action is in no way discretionary--the money must be spent or else problems could easily get worse. Furthermore, the fund is completely funded by the commercial banks--taxpayers have never been called on to pay for bank losses. As long as this remains the case the Bank Insurance Fund does not belong in the federal budget.

Ensure Effective Supervision and Regulation

The IBAA believes regulator supervision of risk management by financial institutions is vital to ensure the safety and soundness of the banking system. At the 25th annual Conference on Bank Structure and Competition sponsored by the Federal Reserve Bank of Chicago, Federal Reserve Board Governor John LaWare said that, instead of regulation, "we need intelligent supervision doing an in-depth job of monitoring what is going on in all these institutions and the authority to move quickly and peremptorily when something goes wrong." Governor Manuel Johnson complemented LaWare's remarks: "To prevent problem banks from becoming threats to the safety net and the financial system, it is necessary to give examiners stronger tools."

In practice, however, community banks often feel field examiners discouraged their use of risk management techniques. Community banks are frequently criticized by examiners for over-concentration in their geographic areas (a risk inherent in community banking). At the same time, banks are cited for "out-of-area" lending when they hold loan participations or have bought loans outside their market area. Examiners sometimes concentrate more on reported accounting earnings for the period rather than true economic cash flows. Therefore, banks are criticized for increased volatility in accounting earnings that often accompanies risk management techniques. The emphasis placed on short-term earnings should be balanced with the long-term effects of risk management techniques.

Community bankers concede that they need more education, guidance and experience in the use of "new" financial instruments and risk management tools. More disclosure in financial statements is needed about complex and generally less familiar financial instruments. The IBAA encourages the banking regulators to develop guidelines for these tools, educate both bankers and examiners in their proper application, and encourage the use of non-traditional risk management techniques such as swaps, hedging, futures and asset securitization. The IBAA also urges the federal regulators to work with state regulators to develop mutually acceptable supervision of these activities.

We urge the banking regulators to facilitate a change in the attitudes of their regional examiners toward risk management techniques. An attitude of acceptance and support is needed to encourage community bankers to become more active in progressive risk management techniques. Education programs directed to both bankers and examiners should be improved. Specialized education would assist examiners in being more sensitive and responsive to local economic conditions and the need for risk management. Bankers need guidance in the proper role risk management instruments can play in their portfolios.

The private sector Accredited Standards Committee X9 on Financial Services has recently established a subcommittee to develop standards for loan documentation. Standardization of loan documents will pave the way for increased asset securitization and easier loan sales. The IBAA recommends that the banking regulators take an active role in the development of loan documentation standards by the private sector, and incorporate these standards into official guidelines for financial institutions.

Increase Capital

We strongly believe that adequate capital is the cornerstone to the safety and soundness of our financial system and to the insurance fund. One of the primary reasons that the thrift industry has had such significant problems is lack of adequate capital. IBAA believes that it is the responsibility of the banking agencies to ensure that the banking industry maintains the appropriate level of capital.

IBAA endorsed the risk-based capital framework when it was proposed several years ago. However, our support of this new framework for measuring capital adequacy was tempered by our concerns that the agencies grant an adequate phase-in for the program to allow time to learn how the system would truly effect the banking industry and also its impact on the regulatory process. We recommended that the agencies, prior to replacing the existing capital ratios, gain sufficient experience with the risk-based capital ratio to make an educated assessment of its usefulness. We also commented that we believed the existing capital ratios should be used in tandem with the risk-adjusted capital ratio at least until the end of 1990. IBAA also does not believe that the agencies are adequately prepared to make complete and accurate assessments of capital adequacy solely on a risk-based framework.

The OCC and the Federal Reserve Board have proposed to retain a minimum leverage ratio in addition to the risk-based capital requirement. Specifically, as of December 31, 1990, national bank and state-member banks will have to satisfy a 3 percent Tier 1 capital-to-total assets ratio and the minimum risk-based capital standard.

The IBAA has expressed its concern to the banking agencies that a 3 percent Tier 1 minimum leverage test is too low. While loan loss reserves are not considered Tier 1 capital, 3 percent pure equity still seems to be an inadequate cushion for safety and soundness. A bank could readily lower its capital provided it developed a low-risk balance sheet profile. However, once a bank lowers its capital, there is nothing to prevent that bank from changing the composition of its balance sheet to one of high risk almost overnight. By the time the regulators recognized a switch like this, it could be too late to require higher capital. Unfortunately, the thrift industry again is a perfect example of what can happen to a federally-insured depository system that switches to high-risk activities without adequate capital.

IBAA believes that an insured financial system requires a higher minimum leverage ratio than is presently being considered by the OCC and FRB. A more adequate minimum leverage ratio would be more than 4 percent Tier 1 capital. The first level of protection of the insurance fund is the bank's capital. When equity is reduced, the risk to the insurance fund increases. Since capital adequacy is assessed on an *ex ante* basis, the insurance fund cannot afford to let a bank whose risk is low today reduce its capital to match that risk without opening the fund to much greater risk tomorrow.

Limits on Brokered Deposits

Brokered deposits are one way for a depositor to obtain "pass-through" deposit insurance coverage. Pass-through insurance permits a depositor who places funds with a third party to obtain full coverage (up to $100,000) as an individual, regardless of how many other depositors are joined in the transactions.

First, we believe that the type of accounts that receive pass-through coverage should be considered. For example, brokered deposits are not core deposits and have been used to the detriment of the insurance funds. IBAA strongly supported the provision in FIRREA that prevents undercapitalized institutions from using brokered deposits. This provision has gone a long way towards correcting the abuses of brokered deposits by institutions that paid above-market rates and used this "hot money" to fund risky activities.

On the other hand, federal deposit insurance is a critical factor in the ability of small banks to attract deposits. IBAA recognizes that pass-through deposit insurance can enhance a small bank's ability to attract funding. Any reduction or limitation of pass-through coverage could negatively affect those institutions' ability to compete the pension funds and other deposits which qualify for the coverage.

Given the existence of a class of large institutions that have *de facto* 100 percent deposit insurance, their support or opposition to pass-through deposit insurance coverage is irrelevant. These large, 100 percent-covered institutions have an advantage over small banks in attracting funding and it is possible that any limitation on pass-through insurance could further impede the small banks' ability to compete.

Alternative Federal Deposit Insurance Systems

In conducting our examination of this issue, we have concluded that there are no credible or feasible alternatives to federal deposit insurance. In particular, our analysis shows that neither private insurance nor "haircuts" are suitable alternatives to the current system of federal deposit insurance.

Private Insurance

Private insurance is unavailable and is unlikely to become available for the vast majority of depository institutions, especially community financial institutions. And neither does the public believe that private insurance would provide them with sufficient protection.

Based upon an independent assessment conducted for the IBAA by Edgar, Dunn and Conover, it appears unlikely that the insurance industry could assume a meaningful role in deposit insurance. Some of the concerns which would likely preclude such a role for the private sector include:

--uneven supervision and enforcement by the regulatory agencies;
--limited access to qualitative data on the condition of a bank;
--lack of timely and accurate data on changes in condition;
--lack of control over assets to mitigate claims expenses; and
--protection of uninsured deposits at too-big-to-fail banks.

If the private sector were to participate at all, its coverage of deposits would not be justified by the premium income from small banks. Given the risk and the administrative cost, the insurance carrier could not make a profit and small banks could not get coverage.

The IBAA therefore believes that the private insurance alternative is not viable, since if implemented at all, it will not be available to the vast majority of banks. And FDIC Chairman Seidman, although suggesting that the private insurance alternative deserves further study, stated in his testimony of February 21, 1990 before the House Banking committee that:

> ...we would like to voice two cautions. First, it will be difficult to fashion a suitable arrangement with private-sector companies that would provide flexibility to accommodate concerns about the effect of a bank failure on macroeconomic stability--that is, private-sector insurance and too-large-to-default may not be compatible. Second, it is important to ensure that the financial capacity exists in the industry to absorb a realistic expectation of loss. The failure of many seemingly solvent state-sponsored funds in the mid-1980s should not be forgotten.

As alluded to by Chairman Seidman in the above statement, although deposit insurance provided at the state level has a long history, such systems have demonstrated marked weaknesses. For example, problems have occurred most recently with private (but state-authorized) deposit insurance in Ohio and Maryland. The entire Ohio system was brought down very quickly by the failure of one institution which was large in relation to the size of the fund.

In another notable breakdown, Maryland Savings and Loan Insurance Corporation, a non-profit corporation created by the Maryland legislature in the 1960s to provide deposit insurance for state-chartered thrifts, failed in the 1980s. Its failure was catastrophic; after years of waiting, some depositors in several failed Maryland-chartered savings and loans have still not received their money. These state-authorized insurance schemes failed when they were needed the most--in times of crisis.

Most depositors in federally insured savings and loans have remained calm in the face of a constant stream of news reports about the crisis in the industry. For more than 50 years the federal deposit insurance system has provided the stability and public confidence unavailable under any other scheme.

Federal deposit insurance makes it possible for thousands of locally-based financial institutions to gather deposits and--under appropriate examination procedures--lend that money to local consumers and businesses. This credit is the lifeblood of thousands of local communities. Without federal insurance these deposits would flow into the nation's too-big-to-fail money center banks and would not be as available to fulfill local credit needs. We strongly recommend that federal deposit insurance remain in place and that private or state deposit insurance systems not be considered as replacements or supplements to the federal guarantee.

"Haircut" Schemes

While the IBAA contends that equality demands that community banks be extended the same 100 percent deposit insurance coverage enjoyed by the too-big-to fail banks, some have argued that there is another path to equality. They say that when a bank fails, all depositors should be given a "haircut"--i.e., forced to take a loss on their uninsured deposits.

We are skeptical that this scheme would be implemented without adding to financial instability. And, there could be severe international ramifications. Several high government officials have said that U.S. banks would be at a disadvantage in comparison to their foreign competitors if we unilaterally eliminated the too-big-to-fail doctrine.

In his February 21, 1990 statement before the House Banking Committee, Comptroller General Charles Bowsher said that:

In today's world, banks operate on a global basis using

> funding arrangements that can be cancelled quickly by use of electronic transfers. Efforts to impose losses on depositors that use these funding arrangements could result in highly destabilizing withdrawals at the first report of problems.

Later on, Bowsher focussed on foreign deposits, saying that:

> ...although deposits in U.S. banks overseas are not formally insured, it is important to be mindful of the argument that if these deposits are not protected, the competitiveness of U.S. banks may be undercut.

FDIC Chairman Seidman, speaking at our recent convention, made a similar point about schemes to impose losses on all uninsured depositors:

> So far we have not found a practical way to do that without taking undue risks to the system, and we have pointed out that the rest of the world apparently has the same too-big-to-fail doctrine, and there is a real question of whether we want to have more potential instability in our system than in the rest of the world.

Robert Clarke, the Comptroller of the Currency, while warning against the danger of adopting reforms that would harm our competitive position in the world, told our convention about the difficulties of reaching an international agreement on this subject, saying that:

> It seems to me that one of the things we have to be awfully careful about in deciding whether anything needs to done to reform the deposit insurance system is to make sure that we don't render our U.S. banks non-competitive against their foreign competitors. We already have too many competitive inequalities in that regard today which need to be fixed and we should not be doing anything that will lead to further competitive inequalities. If we were to establish some sort of system that provides a so-called haircut on all deposits over a particular size in the event of a bank failure, and that same sort of treatment is not afforded depositors in foreign banks, then I think we've set up a competitive inequality that we need to take very seriously.
>
> There are mechanisms, of course, for reaching international agreements such as the...Cook Committee that was the real catalyst for getting the risk-based capital standards adopted on a uniform basis among the G-10 countries. It's possible that a similar mechanism could be used to develop an international accord on deposit insurance, but I think it would be very difficult to get that accomplished given the way other countries handle bank failures.

We think it will take a long time to negotiate any international agreement that abolishes too big to fail. And, it is our understanding that neither the FDIC nor the U.S. Government is aggressively pursuing negotiating such an international accord at this time. We recommend that you carefully consider this aspect before adopting the "haircut" approach. Additionally, Chairman Seidman also stated at our convention that there are serious questions about whether "we have the technical ability to close down a large institution, determine which accounts are insured and which are not insured and open the next day, cutting back to 88 percent or whatever it is on insured accounts over $100,000."

In the meantime, the FDIC should be required to assess foreign deposits and non-deposit liabilities of the large banks. That would bring fairness to the system and additional resources--over $600 million in 1991--into the Bank Insurance Fund.

SHOULD THE CURRENT REGULATORY STRUCTURE BE IMPROVED?

Rather than urge a revamping of the current regulatory structure, the IBAA would urge caution in making any such changes. We do not want a centralized and politicized regulatory scheme. And we have specific concerns regarding proposals to merge the OTS and OCC, and to install a system of functional regulation for community banks.

Merger of OTS and OCC

The IBAA believes that the Office of Thrift Supervision and the Office of the Comptroller of the Currency should remain separate divisions of the Treasury Department. Despite their similarities, banks and thrifts remain separate industries, with separate missions, governed by separate laws and with separate legislative and regulatory agendas. They should be governed by separate regulators. Also, the current regulatory structure has only existed since August 1989. Congress should give the current system more time before revising it--if any revision at all proves necessary. Furthermore, the Bank Insurance Fund--which will continue to be funded by commercial bank premiums--must not be merged with the Savings Association Insurance Fund. That would be an inappropriate way to pay for problems in the savings and loan industry, and it would be unwise to divert resources which may be needed to stabilize the financial system in the future.

Functional Regulation

The proponents of broad deregulation have recommended that even when many different kinds of firms are combined under a single holding company they each be regulated separately, by "function." This may make sense in the case of a major holding company that combines a series of large companies in different lines of business.

In the case of smaller players, like community banks which would offer traditional banking service together with insurance, securities, and real estate sales, functional regulation raises some concerns. Already, our membership is being drowned by paperwork. Complete functional regulation could well discourage community bank entry into new retail services, even if the IBAA's Consumer Financial Services Act (discussed below) is passed.

We realize that in the cases of insurance and real estate some functional regulation may be inevitable, since they are regulated primarily at the state level. However, with respect to securities sales it may make sense for smaller banks' retail securities operations to be regulated by their federal banking regulator. Of course, licensing requirements should be the same as in securities firms, but the banking regulators could enforce them with respect to smaller banks.

A discussion of functional regulation also raises an important, but separate issue of whether one government agency should be given regulatory authority over the holding company. Though some have argued that regulation of the parts makes regulation of the whole unnecessary, we believe that some governmental oversight of the entire enterprise would be essential to protect the wide range of interests involved in a broad-based firm.

Regulation of the "Financial Services Industry"

IBAA sees the wisdom of bringing under the regulatory umbrella the various nonbank institutions which have entered the marketplace over the past decade and perform "bank-like" functions. These new institutions are not required to comply with such regulations as the Community Reinvestment Act and others, while traditional bank organizations are.

IBAA believes there is value in extending regulatory oversight, similar to that exercised over banks, to such funds-gathering entities as money market mutual funds, credit unions, and the credit-granting subsidiaries of many types of commercial firms. This would address such public policy areas as consumer protection, monetary policy, and concerns about the Federal "safety net."

Reducing Compliance and Paperwork Burden

In examining the regulatory structure and its functions, we believe it is critical to recognize that excessive and unnecessary paperwork and compliance requirements are imposing such a severe burden on community banks that it threatens their very survival. Complex laws and regulations are made applicable to all sizes of depository institutions without regard to the source of the problem or the respective institutions' ability to comply. Congress and the regulators have failed to recognize that more often than not the problems they are attempting to rectify are unique to large institutions. This has often resulted in the drafting of unreasonable, burdensome regulations which are unfairly imposed on the small community banks of America.

Many burdensome regulations recently have been adopted under the rationale of consumer protection, with no understanding or concern for the costs of compliance. Oftentimes, the cure is worse than the perceived disease. Complicated new regulations not only result in lowering standards of service for consumers, but they also lead to higher prices. This is particularly problematic for small community banks, as the cost for compliance accounts for a much higher percentage of their expenses than for larger banks, which have significant economy of scale advantages in this area. This places community banks at a competitive disadvantage, for example, vis-a-vis their local credit unions or securities broker, and it results in decreased service and higher prices for the consumer. Credit unions and securities brokers have fewer restrictions and less stringent regulations, thus giving them a further advantage over community banks.

Another aspect of the compliance burden is the threat of punitive action by the regulators for technical or substantive noncompliance with banking regulations. We ask the Committee to strongly urge the regulators to use their enforcement tools fairly and judiciously, since overzealous enforcement could cripple a small bank operation. Instead, compliance should be a mutual goal, with financial institutions being afforded sufficient time by the regulators to learn the correct procedures and to change internal systems to accommodate regulation. The IBAA believes that it is critical that financial institutions be assured of their constitutional rights of due process and urges the regulators to adopt procedures which recognize and incorporate these rights.

We also note that in the last two years, Congress has mandated extensive changes in funds availability, credit card disclosures, home equity loans, and adjustable-rate mortgages. Further consumer legislation would increase the regulatory nightmare for small banks. The IBAA opposes consumer banking legislation, such as the Metzenbaum bills mandating government check cashing and lifeline services, which would increase the overall compliance and paperwork burden of community banks while decreasing service and/or increasing costs for the consumers.

While community bankers strongly support the goal of providing access to essential banking services to all citizens, achieving this goal through government-mandated services is not a proper means of achieving this end. We support banking services, such as direct deposit, that encourage an account relationship and educate the consumer as to the value of using the bank.

All proposals affecting the relationship between consumers and financial institutions should apply across the board to credit unions, insurance companies, brokerage houses, financial conglomerates such as Sears and other retailers, in addition to depository institutions.

IBAA will continue to work to balance legitimate consumer concerns with profitable and feasible banking operations.

Market Value Accounting

Some have suggested that market value accounting would vastly reduce the risk exposure of the deposit insurance system. While we recognize and accept current regulations which require market value accounting for securities held in a bank's trading account and other specifically identified transactions, the IBAA is adamantly opposed to market value accounting for all assets and liabilities of financial institutions. Community bankers do not believe that market valuation can be applied accurately or appropriately to traditional financial instruments. Mark-to-market accounting gives a point-in-time, shut-down picture of the firm. It does not measure the value of the institution as a viable, going concern.

The technical costs inherent in mark-to-market accounting are exorbitant and beyond the capacities of the majority of community banks. Community banks frequently are managed by hands-on owners. Generally small in asset size, they have a few employees and often do not have a CPA on staff. Market valuation would be a gold mine for accounting software firms and other service providers who will cash in on the local community's lack of seasoned and sophisticated accounting professionals.

Market value accounting would be particularly devastating to local communities and small businesses. Loans to small, local businesses are difficult to value. Financial institutions are likely to respond to mark-to-market accounting rules by making only loans that qualify for sale in the secondary market. This would change markedly the way most community banks do business. It could significantly hamper the community bank's ability to serve its local community. It would shut out many small businessmen and women from loans normally provided by community bankers who know and invest in their community.

Mark-to-market accounting would significantly affect how community banks manage their assets and liabilities. The IBAA is concerned that market value accounting may induce portfolio management based on accounting rules, rather than to ensure the safety and soundness of banking activities. Accounting rules should be the means to the end of reporting the institution's financial condition. Market value accounting may become an end by forcing bankers to seek investment alternatives based on accounting treatment, rather than based on liquidity, cash flow and other economic needs.

DEREGULATION

Mr. Chairman, your letter of invitation also asked, "Should new powers be granted to banks or their affiliates?" The last time we formally addressed the Committee on deregulation was in December of 1987. Much has changed since then--Congress has had to pass a major bailout for the thrift industry and the European Community's financial integration plans for 1992 have heightened concern about our banks' competitive position in the world. While we recognize that much has changed, we should not lose sight of things which have not changed.

Deregulation is still a solution in search of a problem, as it has been for ten years. It has been touted as a way to increase banks' market share, sometimes to improve their profitability, and now we are told that deregulation will help our major international banks--about 10--compete overseas. Occasionally, deregulation is even suggested as a way to improve service for the person on the street. This is the approach we prefer. That is why we have proposed the Consumer Financial Services Act, which would permit all banks to offer a full range of financial products to their customers.

We still believe that Congress should impose a two-part test on any deregulation proposal: will it improve service for consumers and will it promote the stability of the financial system? The validity of this test has not changed since December 1987, and we do not expect it to change in the future.

On the basis of this test we still oppose radical deregulation proposals, such as the repeal of the Glass-Steagall Act or even more drastic financial "restructuring" proposals like H.R. 1992. We will vigorously oppose any proposal which violates the separation of banking and commerce. We prefer an incremental approach to granting banks additional powers, rather than repeal of laws like Glass-Steagall. Deregulation benefits only a handful of American banks. According to Fed Chairman Greenspan, in his April 4, 1990 testimony to the LaFalce Task Force on International Competitiveness, "international banking is and has been concentrated in a small number of U.S. banks. Four out of the 10,000 U.S. banking organizations account for roughly half of international assets; 10 of those account for a little over 80 percent."

I will turn first to our own proposal and then discuss our views on other deregulation ideas.

IBAA's Proposal

Last year the IBAA proposed the Consumer Financial Services Act (summary and bill attached). Its purpose is to permit banking organizations to offer a full range of retail financial services to their customers. And, because it does not grant new underwriting power, except in one narrow instance, our bill does not threaten the stability of the system as do more radical proposals. It meets the two-part test we recommend that you use.

Specifically, our bill would give national banks and bank holding companies the power to sell insurance and securities products to their customers and to broker real estate. They could also underwrite municipal revenue bonds, a logical extension of the current power to underwrite general obligation bonds. They would not get the power to underwrite insurance, securities, or invest in real estate.

Our bill would also recognize the states' ability to grant these same retail powers to state-chartered banks. However, the FDIC or the Federal Reserve could block a state bank's use of these new powers if necessary to prevent unsafe or unsound banking practices. The federal authorities could not block banks from using these powers by rule or regulation. We believe that these kinds of retail powers present no general safety and soundness concerns and so there is no need to give the federal government general power to block their use. At the same time, we do not completely rule out federal action in isolated cases.

Consumers could benefit from the IBAA's proposal by permitting banks to give them easier access to all the financial options available. Many of their nonbank competitors, such as insurance agents and securities brokers, already offer this range of service, including bank and bank-like products.

This makes a lot of sense, because consumers need a variety of products over the course of their financial lives. Young parents have less cash available for savings, but should have ample insurance coverage; middle-aged people accumulate savings for retirement using a diverse portfolio that may include both bank products and securities; while retirees may well prefer the security of certificates of deposit or annuities. Bankers understand that their banks' own products are needed at all stages, but may not be suitable for all purposes.

A bank is a particularly good setting for customers to shop for a variety of financial products. There is less potential for conflicts of interest when banks offer retail insurance or securities products unconnected to an ownership interest in the underwriting company. The bank can focus on the needs of its customers rather than being overly concerned about the effects of a sale on the company that originates it. While they have a special stake in selling a customer a bank product, they have a greater stake in maintaining a solid relationship with that customer.

Since these kinds of agency operations do not pose risk to the federal safety net, we recommend that banks have the option of exercising their new powers under whatever corporate structure they choose. Under our bill sales could be made by a bank itself, by a bank subsidiary, or by a subsidiary of a holding company. Many banks do not wish to go to the expense of setting up a holding company structure, while others prefer more separation. This should be a business, not a regulatory, decision. Since there are few potential financial "fires" in an agency operation, we do not believe that elaborate firewalls are necessary.

Given the importance to customers of having the widest range of options available, we drafted the Consumer Financial Services Act to include all retail financial services. The last time Congress considered deregulation proposals the new powers were strictly limited to securities and focussed primarily on underwriting--last on the list of interest for community banks. In fact, the Senate and two House committees adopted provisions to cut back on insurance powers for banks--the service our banks are most interested in--and the House Banking Committee proposed a permanent ban on new bank real estate powers.

We will strongly oppose legislation that contains these kinds of provisions. If Congress does nothing else it should reject attempts to bar banks from offering the kind of retail services included in our legislation. As you know, some states and federal agencies do have the authority to permit banks to offer some of these services.

Of course, if Congress moves major deregulation legislation it should include provisions such as those in the Consumer Financial Services Act, and not simply wait for state initiative. We cannot support a bill that leaves us "waiting at the altar."

Insurance Services

Our members are particularly interested in offering insurance services. That is why it is first in our bill. While we understand that this is controversial in some quarters, it should become less and less so. In 1988 the voters of California decided to permit banks to sell insurance. California joins a long list of states that already permit this. We have many state-chartered members in states like Minnesota and Iowa that have sold insurance for years.

Some have argued that the recent Court of Appeals decision in the Merchants National case gives states too much of an opening to grant risky new powers to state-chartered banks. They raise the concern that the case could lead to financial concentration and risk to the federal safety net. However, states and state banking commissioners are not poised to grant a host of risky new powers to their state-chartered banks. And, the record of commercial bank regulation at the state level has been very reassuring in that regard. In any event, the FDIC and the Federal Reserve have enough regulatory tools to prevent undue risk to the deposit insurance fund.

Vice Chairman of the Federal Reserve Manuel H. Johnson made this same point in his April 4, 1990 testimony before the House Banking Committee, and added: "Agency activities do not raise the risk-related and competitive concerns that would justify placing restrictions on the state-authorized powers."

Broader Deregulation Proposals

As I said at the outset, we remain opposed to legislation that would repeal Glass-Steagall or that would go even farther and permit banks to affiliate with any kind of company. This is not really a powers question, it is an ownership question. As the discussion about the Consumer Financial Services Act makes clear, it is not necessary for financial firms to be under one corporate roof for consumers to have access to the full range of products. And there are significant disadvantages to common ownership because of potentially increased financial instability and concentration.

The Safety Net

With the savings and loan crisis still on the nation's front pages, it will be difficult to support proposals that threaten the federal support system--deposit insurance, the Federal Reserve discount window, and the payments system.

Supporters of broad deregulation proposals generally claim that extensive firewalls between insured banks and newly authorized activities will adequately protect the bank and the federal safety net. We are skeptical that firewalls would be effective when they are needed most--in times of crisis. As a result, the federal support system could be severely strained if the firewalls melt.

The 1987 stock market crash provided an example of how this could happen. The Continental Illinois bank (which was essentially owned by the federal government) extended a substantial loan to its securities clearing subsidiary, First Options, when the subsidiary's customers could not meet their obligations. In that case, Continental and its regulator, the Comptroller of the Currency, were in close communication throughout the day discussing how far Continental could go in assisting its subsidiary. Nevertheless, the bank's loan to First Options had to be transferred to the bank's holding company because the Comptroller's office later determined that it violated the lending limit it had set for loans from the bank to First Options.

Some have argued that Continental really had no choice; that it had to bail out its subsidiary for its own good, and for the good of the system. This may have been the case, but that simply underscores the problem posed by the affiliation of banks and full-service securities firms.

In the Continental/First Options situation, one regulator was unable to completely police one "firewall" that it had erected between one bank and one subsidiary. Consider what could happen if the Glass-Steagall Act is repealed and there are hundreds of banks with full-service securities affiliates. If the Comptroller's office was unable to police just one firewall within one banking organization what confidence should we have that it and the other agencies could, when a crisis strikes, bar hundreds of banking institutions from violating the scores of new restrictions that have been proposed.

More generally, academic studies indicate that "bank regulators currently are able to project only two-thirds of bank failures a year in advance" and "our bank regulatory system failed to catch Penn Square, Continental Illinois and SeaFirst before they failed." (Litan, Robert E., "Which Way for Congress?", Challenge, November-December, 1987, p. 39.) It seems obvious to us that the present regulatory state of the art has a long way to go before firewalls will work in a fully deregulated setting.

The large number of potential dangers is highlighted by the list of restrictions that have been proposed. We share these concerns that gave rise to these proposals, and are worried that the degree of supervision necessary to enforce them in a time of crisis would have to be so intrusive that it would threaten the very concept of a privately-owned and operated financial system.

This kind of control is very different from traditional bank supervision. Traditionally, bank examiners study a bank's loan portfolio to determine if the loans are performing. If there has been too much deterioration over time, and too many loans are classified, the bank is put on a problem list, or even closed. Generally, these kinds of problems develop over months or years and can be handled by regular examinations, say one every 12 or 24 months. This kind of sporadic supervision is clearly insufficient to guard against abuses of the firewalls contemplated by the agencies. Banks and their holding companies would have to report virtually on a daily basis, even hourly in times of crisis, so that the regulatory agencies could ensure that regulations were not being violated.

One reaction to this has been a call to eliminate the firewalls altogether, which is a call for a "universal bank" like those that exist in Europe. It is hard to take these recommendations seriously, as long as the new universal bankers want to continue to participate in the federal support system. But they do illustrate some of the difficulties posed by radical deregulation and accompanying firewalls. But rather than have radical deregulation without firewalls, we believe prudence dictates avoiding radical deregulation altogether.

There is another aspect of the firewall problem that has not been discussed much, but will need to be in the face of calls for ever-more expansive cross-ownership between banks and other firms. Until now, most of the focus has been on the risks these firms pose to the bank and to the federal safety net. But the recent case where the federal government insisted that an Arizona public utility contribute to the bailout of a troubled thrift makes clear that the problem can go both ways.

When an insured depository institution gets into trouble the federal government could properly insist that its holding company and affiliates step in with funds before the deposit insurance funds, and ultimately the taxpayers, are asked to contribute. Under the most radical deregulation scheme utility rate payers, securities investors, and insurance policy holders may be asked, however indirectly, to pay for losses incurred by federally-insured institutions. These innocent bystanders could be put at substantial risk, just because the company they do business with was affiliated with a federally insured depository institution.

Concentration of Power

We remain concerned that common ownership will lead to greater concentration of financial, and eventually political, power in our nation. Just as the two-party system ensures a forum for fair, meaningful debate in government, a diversified financial system is a cornerstone of our nation's economy.

There is considerable value in having a multitude of financial service providers all proceeding independently. This fosters the kind of open economy where a person or company with an idea can look to a variety of funding sources, rather than being confronted with a small number of "universal banks." Small business thrives in this kind of environment. And small business is this country's most prolific job creator. Universal banks will not relate well to small business--they will favor major corporations. Those corporations will have a favored place in seeking funding for their operations, increasing concentration throughout the economy.

And not only will economic power become more concentrated, so will political power. Interests tied to major financial institutions and major corporations, not to local people and local small business, will increasingly dominate political life. Is this the kind of world we want to create?

Avoid Concentration--Go Step-by-Step

Many of the problems of concentration could be avoided by pursuing a step-by-step approach to deregulation. That is what our Consumer Financial Services Act is designed to do. It was also the basis of the House's approach to Glass-Steagall reform in 1988. Bank holding company securities subsidiaries were given a limited list of securities powers.

The step-by-step approach would add new competitors to the financial marketplace. In contrast, wholesale financial restructuring--permitting cross-ownership of all types of firms--does not add to competition. We do not see how competition in either the banking or, for example, the securities industries is enhanced when existing companies simply buy each other. No new competitors are added to either industry. Instead, the corporate deck is reshuffled and ever larger institutions are created. If Congress thinks the securities industry is too concentrated--and that is frequently asserted--it should pass legislation that encourages banks to enter that business without buying major securities firms.

The step-by-step approach which we favor would have just this result. Each step could be small enough to discourage major banks from buying major securities firms--or vice versa--but large enough to draw banks into the industry on their own. There would be no need for specific concentration limits and no manipulation of balance sheets to avoid those limits.

Some argue that this approach is unfair, that it is not a two-way street for banks and securities firms. If the phrase had not been worn out by overuse, some might even argue that it does not provide a "level playing field." Frankly, if Congress makes this its ultimate goal, it will have about as much luck as Diogenes had in finding an honest man.

If there is concern about inter-industry fairness, we argue that the step-by-step approach does provide some rough justice. As it stands, securities firms have cut into banks' deposit and lending business by offering such products as cash management accounts, money market mutual funds and commercial paper. These are not always perfect substitutes for bank products, but then neither would a limited list of securities powers be a perfect substitute for full-scale entry into the securities business.

Interestingly, the Federal Reserve's approach under Section 20 of the Glass-Steagall Act adopts this step-by-step approach. New competitors have been added to important facets of the securities business, and no securities underwriter has been bought by a bank. At a time of increasing concentration among traditional securities firms, new entry by bank affiliates is certainly a positive development.

The Federal Reserve's approach also gives the financial industry an opportunity to experiment with firewalls. As we indicate elsewhere in our testimony, we are very skeptical that firewalls can really work as intended. If Congress shares this skepticism, it certainly makes sense to experiment on a limited basis rather than simply take a blind leap of faith.

Cross-marketing

We believe that if there is wholesale restructuring of our financial system, community banks could face unfair competition from banks under common ownership with wholesale financial firms, such as insurance and securities companies. For example, an insurance company might offer its bank's customers more favorable terms than it offers to other customers, such as those of unaffiliated banks. Banks with no ownership tie with an insurance company could be put at a substantial competitive disadvantage. If we wish to maintain retail banks and other firms that are unaffiliated with wholesale firms, Congress will have to ensure that free-standing institutions have fair access to financial products.

International Competitiveness

As stated above, deregulation has been a solution in search of a problem for the past ten years. The latest problem deregulation is supposed to solve is our nation's banks difficulty in competing in the international marketplace.

Much has been made of the fact that there is only one U.S. bank among the top 25 in the world. Almost as much is made of the fact that most of the banks on this list of international "big hitters" are Japanese. We think this focus on size is a diversion--and a dangerous diversion.

The Federal Advisory Council--a statutory group of big-bank representatives that meets with the Federal Reserve's Board of Governors four times each year--discussed last year whether the government policy should attempt to reduce the number of banks in this country to 500.

This would, of course, push some U.S. banks into the upper size ranks--but at a high cost. Before we make massive changes in our domestic financial structure in an effort to improve our international competitiveness, we must consider what those kinds of changes will do to our domestic situation. Communities all over the country would lose their locally owned banks, their engines of prosperity. Our diversified economy, with its heavy emphasis on small business-driven job growth, would change quickly. Credit would flow to big business with close ties to big banking. It would flow out of small-town America.

And what would we gain from this kind of radical restructuring? Probably nothing. There is no evidence that the U.S. financial markets, including banks, securities firms, insurance companies, and other financial players cannot finance U.S. industry. And there is no evidence that, just because of their relative size, our banks have not been competitive.

The key issue is profitability, not size. A March 27, 1990 article in the American Banker suggests that U.S. banks themselves are not seeking growth for its own sake. In commenting on the decreasing share of deposits held by the ten largest banks, the article said that "the decline reflects the fact that large banks no longer consider asset and deposit growth as desirable, unless profits grow accordingly."

We also noted with interest Federal Reserve Board Chairman Greenspan's comments recently before a House Banking Committee task force on international competitiveness:

> A proper assessment of how well U.S. banks are competing today in a new global competitive setting must recognize several points. First, U.S. banks are not all alike. In particular, only a very small subset of U.S. banks is active internationally...measures of total assets, or market shares relating to particular national markets, can be very misleading as measures of international competitiveness, partly for the reasons I have already mentioned: only a handful of U.S. banks are internationally active, and a significant element of their international business does not show up on their balance sheets...instead, international banking is and has been concentrated in a small number of U.S. banks. Four out of the 10,000 U.S. banking

organizations account for roughly half of international assets; 10 of those account for a little over 80 percent.

It does not make sense to radically change our entire financial system just to accommodate the international aspirations of a few international banks.

Of course, we agree that Congress should act to keep our financial markets healthy, but it should not take hasty action just to make sure we have "X" number of commercial banks in the top 25.

That would only deal with a symptom of our economic problems. The health of our financial sector depends on the condition of the economy. As we all know, we are running a huge trade deficit with Japan, and the Japanese are funding much of our federal budget deficit. Obviously, this affects the relative sizes of our financial institutions.

There may be other factors at work, as well, that are tied to specific features of the Japanese situation. It is interesting that, in terms of market capitalization, all the banks in the top 20 are Japanese and the Japanese control 15 out of the top 20 in asset size. And, it is not just the U.S. banks that have been pushed out of the picture; other major countries' banks have been affected.

This Japanese dominance may be accounted for by things which have next to nothing to do with the U.S. financial structure, or the financial structure of other countries. Let me suggest some things which may help account for the relative size of Japanese banks--most of which greatly lower their cost of capital:

-- the Japanese manufacturing sector is very strong;

-- the Japanese savings rate is extremely high;

-- until recently the yen was soaring; and,

-- the Japanese stock market, until the past few weeks, has defied experts who kept saying, "it simply can't go higher."

No one has suggested that policies that increase financial concentration in the U.S. will have any effect whatsoever on these important facts. We hope that Congress will not focus on the relative size of U.S. commercial banks, but will ask in very specific terms what we should do to make our economy and our financial sector competitive in today's world.

Finally, we noted with interest the suggestion of Comptroller General Charles Bowsher, when testifying on February 21, 1990 before the House Banking Committee, that a two-tier system may be appropriate: "We believe it is appropriate to consider changing the way big banks are regulated and insured.

In return for certain special protections, higher premiums or premiums on all deposits may be necessary." In this statement, Mr. Bowsher was referring to the too-big-to-fail policy. We feel that further study of an expanded version of this concept is warranted. It could tie the undertaking of risky new activities which increase U.S. government exposure to curtailments of safety net protections, including deposit insurance. Let those who want to engage in new risky activities face higher premiums or coverage adjustments. These are current generally accepted principles in the insurance industry.

Conclusion

Mr. Chairman, the IBAA shares your vision of an America competitive at home and abroad. We believe that we have set forth recommendations that can help assure us of attaining that goal. We recognize that there are many competing interests and different ideas on how to approach the future for the financial services industry, however. We therefore repeat our pledge to work with the Congress and the Administration in attempting to devise a plan which will set the stage for competing in the world marketplace, while maintaining a strong, diverse and fair system of community banking for Main Street America.

Thank you for the opportunity to present our views on these important issues.

TABLE 1

BANK INSURANCE FUND RESERVES:
ONLY DOMESTIC DEPOSITS ASSESSED

(in billions of dollars)

Bank Insurance Fund reaches 1.25 target reserve level in 1993 as currently measured against insured deposits.

Bank Insurance Fund reaches 1.25 target reserve level in 1995 if measured against total domestic deposits.

	1988	1989	1990	1991	1992	1993	1994	1995
PREMIUM ASSESSMENT	0.083	0.083	0.12	0.15	0.15	0.15	0.15	0.15
TOTAL DOMESTIC DEPOSITS	2,331	2,448	2,570	2,698	2,833	2,975	3,124	3,280
TOTAL INSURED DEPOSITS	1,750	1,836	1,927	2,024	2,125	2,231	2,343	2,460
ASSESSMENT INCOME	1.77	2.03	3.08	4.05	4.25	4.46	4.69	4.92
INVESTMENT INCOME	1.57	1.12	1.14	1.27	1.54	1.88	2.31	2.79
TOTAL INCOME	3.34	3.16	4.22	5.32	5.79	6.35	7.00	7.71
TOTAL INCOME	3.34	3.16	4.22	5.32	5.79	6.35	7.00	7.71
EXPENSES	7.59	3.00	2.50	2.00	1.50	1.00	1.00	1.00
NET INCOME	(4.25)	0.16	1.72	3.32	4.29	5.35	6.00	6.71
TOTAL FUND RESERVES	14.06	14.22	15.94	19.26	23.55	28.90	34.89	41.61
COVERAGE RATIO OF INSURED DEPOSITS	0.83	0.77	0.83	0.95	1.11	1.30	1.49	1.69
COVERAGE RATIO OF TOTAL DOMESTIC DEPOSITS	0.60	0.58	0.62	0.71	0.83	0.97	1.12	1.27

Assumptions:	5% annual growth in assessable deposits Insured deposits/total deposits = 75% FDIC investment yield on Treasuries = 8%

Source for 1988 figures on domestic and insured deposits, assessment and investment income, expenses and total fund reserves: FDIC 1988 ANNUAL REPORT

TABLE 2

BANK INSURANCE FUND RESERVES:
DOMESTIC AND FOREIGN DEPOSITS AND NON-DEPOSIT LIABILITIES ASSESSED

(in billions of dollars)

Insurance Fund Reaches 1.25 Optimal Target Level in 1996

	1989	1990	1991	1992	1993	1994	1995	1996
PREMIUM ASSESSMENT	0.083	0.12	0.15	0.15	0.15	0.15	0.15	0.15
LIABILITIES								
FOREIGN DEPOSITS	331	344	358	372	387	403	419	436
OTHER LIABILITIES	220	231	243	255	267	281	295	310
SUBTOTAL	551	575	601	627	655	683	714	745
DOMESTIC DEPOSITS	2.350	2,468	2,591	2,720	2,856	2,999	3,149	3,307
TOTAL ASSESSABLE BASE	2,901	3,043	3,191	3,347	3,511	3,683	3,863	4,052
ASSESSMENT INCOME								
DOMESTIC DEPOSIT INC.	1.95	2.96	3.89	4.08	4.28	4.50	4.72	4.96
FOREIGN DEP. INCOME		0.413	0.537	0.558	0.581	0.604	0.628	0.653
OTHER LIABILITY INC.		0.277	0.364	0.382	0.401	0.421	0.442	0.464
SUBTOTAL	1.95	3.65	4.79	5.02	5.27	5.52	5.79	6.08
INVESTMENT INCOME	1.12	1.13	1.31	1.64	2.05	2.55	3.12	3.75
TOTAL INCOME	3.07	4.78	6.09	6.66	7.31	8.08	8.91	9.83
EXPENSES	3.00	2.50	2.00	1.50	1.00	1.00	1.00	1.00
NET INCOME	0.07	2.28	4.09	5.16	6.31	7.08	7.91	8.83
FUND RESERVES	14.07	16.35	20.44	25.60	31.91	38.99	46.90	55.73
COVERAGE RATIO OF TOTAL ASSESSABLE BASE	0.49	0.54	0.64	0.76	0.91	1.06	1.21	1.38
FDIC FUND YE 1988	14.00							

ASSUMPTIONS:		
	ANNUAL DEPOSIT GROWTH	5%
	FOREIGN DEPOSIT GROWTH	4%
	OTHER LIABILITIES GROWTH	5%
	INVESTMENT YIELD - TREASURIES	8%

Source for 1989 figures: FDIC Office of Research and Statistics

TABLE 3

PROJECTED INCOME FROM FOREIGN DEPOSIT ASSESSMENT

	1990	1991	1992
Premium Assessment	0.12	0.15	0.15
Foreign Deposits With Growth At 5 Percent	348	365	383
Income to the Bank Insurance Fund	0.417	0.547	0.575
Foreign Deposits With No Growth	331	331	331
Income to the Bank Insurance Fund	0.397	0.497	497
Foreign Deposits With Growth At -5 Percent	314	299	284
Income to the Bank Insurance Fund	0.377	0.448	0.426
Foreign Deposits With Growth At -10 Percent	298	268	241
Income to the Bank Insurance Fund	0.357	0.402	0.426

TABLE 4

BIF ASSESSMENT INCOME FROM DOMESTIC AND FOREIGN DEPOSITS AND NON-DEPOSIT LIABILITIES OF THE 30 LARGEST COMMERCIAL BANKS

(in millions of dollars)

If the foreign deposits and non-deposit liabilities of these too-big-to-fail banks were assessed, over $550 million of additional funds ($355 million from foreign deposits; $219 million from non-deposit liabilities) would be added to the Bank Insurance Fund to cover these de facto liabilities.

BANK NAME TO FDIC	TOTAL ASSETS	DOMESTIC DEPOSITS	INCOME TO FDIC	FOREIGN DEPOSITS	INCOME TO FDIC	NON-DEPOSIT LIABILITIES	INCOME TO FDIC	TOTAL INCOME
Citibank	158,535	43,536	52.24	65,849	79.02	20,632	24.76	156.02
Bank of America	84,755	51,284	61.54	19,143	22.97	6,028	7.23	91.75
Chase Manhattan Bank	82,711	27,987	33.58	32,882	39.46	10,885	13.06	86.10
Morgan Guaranty Trust	65,164	7,626	9.15	33,562	40.27	11,217	13.46	62.89
Security Pacific NB	56,724	31,075	37.29	6,981	8.38	11,214	13.46	59.12
Manufacturers Hanover	55,016	23,125	27.75	19,069	22.88	6,633	7.96	58.59
Bankers Trust Co.	50,314	12,842	15.41	18,663	22.40	7,663	9.20	47.00
Chemical Bank	49,353	25,602	30.72	8,399	10.08	10,586	12.70	53.50
Wells Fargo Bank	45,408	34,022	40.83	256	0.31	7,038	8.45	49.58
First NB of Chicago	37,724	12,895	15.47	14,526	17.43	7,558	9.07	41.97
Continental Bank	31,621	12,510	15.01	6,600	7.92	9,199	11.04	33.97
NCNB Texas NB	29,470	20,737	24.88	1,316	1.58	5,602	6.72	33.19
The Bank of New York	27,656	12,906	15.49	8,919	10.70	3,937	4.72	30.91
First NB of Boston	27,107	11,840	14.21	6,096	7.32	6,400	7.68	29.20
Irving Trust Co.	23,563	6,768	8.12	10,026	12.03	3,540	4.25	24.40
Mellon Bank	22,563	11,354	13.62	4,092	4.91	5,440	6.53	25.06
Marine Midland Bank	21,605	14,069	16.88	3,371	4.05	2,917	3.50	24.43
Republic NB of NY	21,363	5,592	6.71	9,058	10.87	3,821	4.59	22.17
First Interstate	20,780	16,223	19.47	1,187	1.42	1,594	1.91	22.80
NCNB of N. Carolina	18,085	10,468	12.56	1,210	1.45	5,087	6.10	20.12
First Union NB of NC	17,977	9,383	11.26	532	0.64	7,069	8.48	20.38
Ntl Bank of Detroit	16,410	10,714	12.86	1,467	1.76	3,115	3.74	18.36
Pittsburgh NB	15,967	9,755	11.71	350	0.42	4,855	5.83	17.95
Union Bank	15,782	10,501	12.60	675	0.81	3,233	3.88	17.29
Wachovia B & T	14,974	11,169	13.40	336	0.40	2,456	2.95	16.75
Bank of New England	14,681	7,499	9.00	1,618	1.94	4,025	4.83	15.77
Southeast Bank	14,317	9,854	11.82	953	1.14	2,699	3.24	16.21
Ntl Westminster	14,241	10,005	12.01	1,709	2.05	2,027	2.43	16.49
First Bank	13,305	8,669	10.40	665	0.80	2,944	3.53	14.73
Sovran Bank	13,272	9,652	11.58	100	0.12	2,681	3.22	14.92
TOTAL	1,080,443	489,662	587.59	279,610	335.53	182,095	218.51	1,141.64

*0.12 Percent is used as the assessment rate

*figures are as of September 30, 1989 from the FDIC Office of Research and Statistics

TABLE 5

POTENTIAL INCOME TO THE BANK INSURANCE FUND FROM THE 30 LARGEST COMMERCIAL BANKS

($ millions)

If assessments were collected on all liabilities,
the income to the Bank Insurance Fund would be increased by $555 million.

	TOTAL LIABILITY	ANNUAL INCOME TO FDIC CURRENT	 POTENTIAL
DOMESTIC DEPOSITS	$489,662	$588	$588
FOREIGN DEPOSITS	$279,610	$0	$336
NON-DEPOSIT LIABILTIES	$182,095	$0	$219
TOTAL	$951,367	$588	$1,143

Based on 1990 premium assessment rate of 0.12 percent
Source: FDIC Office of Research and Statistics
Figures are as of September 30, 1989.
See Table 8 for detail.

IBAA's Proposal For A

"CONSUMER FINANCIAL SERVICES ACT"

Summary

Section 1. *Short Title.* "Consumer Financial Services Act"

Section 2. *National Bank Services.* Gives all national banks the following powers: insurance sales, real estate brokerage, securities brokerage, municipal securities underwriting, and mutual fund sales.

Section 3. *Bank Holding Company Services.* Gives the new national bank powers to bank holding companies.

Section 4. *State-chartered banks.* Prevents the FDIC and the Fed from blocking, by rule or regulation, banks, or their subsidiaries, from using the powers granted to national banks and bank holding companies. They could still step into individual cases involving state-chartered banks, but only on safety and soundness grounds (and only the FDIC could use this authority with respect to bank subsidiaries). It would still be up to the states to grant the powers, though many already do in parity statutes that give state-chartered banks any national bank power.

Section 5. *Bank Holding Company Procedures.* Provides expedited holding company formation procedures.

Section 6. *Farmer Mac - Lending Limits & Capital.* Clarifies the regulatory treatment of lending limits for national banks, by providing that the portion of the loan sold without recourse will not be counted against the originating bank's lending limit. This section also says that Federal banking agencies may not consider the portion of the loan sold without recourse as an asset in calculating capital requirements.

Section 7. *Bankers' Bank Provisions.* Technicals relating to holding companies and an increase in the bank stock loan limit in the Federal Reserve Act increased from 10% to 15%. This conforms it to the National Bank Act limit.

Section 8. *Paperwork Reduction.* Strikes out the section of the Regulatory Flexibility Act that now permits an agency to waive the act if it certifies it will not affect a "substantial" number of small entities. A regulatory impact analysis would be required for all regulations.

This section also increases the Home Mortgage Disclosure Act exemption for small banks from $10 million to $50 million and provides for an automatic inflation adjustment. ■

IBAA's Proposal For A "CONSUMER FINANCIAL SERVICES ACT"

A Bill

To permit commercial banks to offer consumers a full range of financial services and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. SHORT TITLE.

(a) Short Title. This Act may be cited as the "Consumer Financial Services Act."

SECTION 2. NATIONAL BANK SERVICES.

(a) Insurance Services. Section 5202 of the Revised Statutes (12 U.S.C. 92) is amended by striking out "located and doing business in any place the population of which does not exceed five thousand inhabitants, as shown by the last preceding decennial census,".

(b) Real Estate Services. Section 5202 of the Revised Statutes (12 U.S.C. 92) is further amended by inserting the following immediately following "insurance company for which it may act as agent;"--

"may also provide real estate agency and brokerage services;"

(c)(1) Securities Services. Section 5136 of the Revised statutes (12 U.S.C. 24) is amended by --

(1) striking in paragraph Seventh "The business of dealing in securities and stock" and all that follows through "for its own account" and inserting in lieu thereof --

"An association may engage in the securities activities provided for in this paragraph (Seventh) and in paragraph Eleventh of this section but may not purchase and sell securities for its own account", and

(2) adding the following new paragraph --

"Eleventh. Securities Brokerage, Mutual Fund Sales, and Municipal Revenue Bond Underwriting. An association may --

"(a) engage in securities brokerage, investment advisory services, financial advisory services, and such additional securities activities not constituting underwriting, distributing, or dealing in securities as are permitted for brokers or dealers registered under the Securities Exchange Act of 1934 or for investment advisors registered under the Investment Advisers Act of 1940;

"(b) buy and sell, as principal or agent, and underwrite municipal securities; and

"(c) may distribute securities of an investment company --

"(1) that is registered pursuant to section 8 of the Investment Company Act of 1940;

"(2) that is not organized, sponsored, managed, or controlled by the association or any company that is affiliated with the association through a bank holding company; and

"(3) for which neither the association nor any company that is affiliated with the association through a bank holding company acts as an investment advisor."

SECTION 3. BANK HOLDING COMPANY SERVICES.

(a) Securities and Real Estate. Section 4(c)(5) (12 U.S.C. 1843(c)(5)) is amended by striking out "section" and inserting in lieu thereof "sections" and inserting "(12 U.S.C. 24) and 5202 (12 U.S.C. 92)" immediately following "5136".

(b) Insurance. Section 4(c)(8) is amended by --

(1) striking out ", agent, or broker" immediately before "except (A)", and

(2) striking out subparagraphs (C), (D), (F), and (G) and redesignating subparagraph (E) as (C).

SECTION 4. STATE-CHARTERED BANK SERVICES.

(a) Non-member Banks. Section 18 of the Federal Deposit Insurance Act (12 U.S.C. 1828) is amended by adding at the end thereof the following new subsection --

"(o)(1) General Rule. The Corporation may not by rule or regulation prevent a bank, or subsidiary thereof, from offering the services permitted for national banks and bank holding companies under the Consumer Financial Services Act. The Corporation may prevent a state bank, or subsidiary thereof, from offering or continuing to offer any such service only if it determines such action is necessary to prevent unsafe or unsound banking practices.

"(2) Rule of Construction. Except as directly provided in the second sentence of paragraph (1), nothing in this subsection may be construed to permit the Corporation to prevent a bank, or subsidiary thereof, from engaging in any activity permitted under federal or state law, rule, regulation, or order."

(b)(1) Member Banks. The Board of Governors of the Federal Reserve System may not by rule or regulation prevent a bank (as defined in section 3 of the Federal Deposit Insurance Act), or subsidiary thereof, from offering the services permitted for national banks and bank holding companies under the Consumer Financial Services Act. The Board may prevent a state bank that is a member of the Federal Reserve System from offering or continuing to offer any such service only if it determines such action is necessary to prevent unsafe or unsound banking practices.

(2) Rule of Construction. Except as directly provided in the second sentence of paragraph (1), nothing in this subsection may be construed to permit the Board to prevent a bank, or subsidiary thereof, from engaging in any activity permitted under federal or state law, rule, regulation, or order.

SECTION 5. EXPEDITED PROCEDURES FOR FORMING A BANK HOLDING COMPANY; EXEMPTION FROM SECURITIES REGISTRATION.

(a) Expedited Procedures. Section 3(a) of the Bank Holding Company Act of 1956 (12 U.S.C.1842(a)) is amended-

(1) by striking out "or (B)" and inserting in lieu thereof "(B)",

(2) by inserting before the period at the end of the second sentence the following: "; or (C) with 30 days prior notification to the Board, the acquisition by a company of control of a bank in reorganization in which a person or group of persons exchange their shares of the bank for shares of a newly formed bank holding company and receive, after the reorganization, substantially the same proportional share interest in the holding company as they held in the bank except for changes in shareholders' interests resulting from exercise of dissenting shareholders' rights under State or Federal law if, immediately following the acquisition, the bank holding company meets the capital and other financial standards prescribed by the

Board by regulation for such a bank holding company and the holding company does not engage in any activities other than those of banking or managing and controlling banks. In promulgating regulations pursuant to this subsection, the Board shall not require more capital for the subsidiary bank immediately following the reorganization than is required for a similarly sized bank that is not a subsidiary of a bank holding company".

(b) Registration Exemption. Section 4 of the Securities Act of 1933 (15 U.S.C. 77d) is amended by adding at the end of thereof the following new paragraph:

"(7) transactions involving offers or sales of equity securities, in connection with the acquisition of a bank by a company under section 3(a) of the Bank Holding Company Act of 1956 (12 U.S.C. 1842(a)), if the acquisition occurs solely as part of a reorganization in which a person or group of persons exchange their shares of a bank for shares of a newly formed bank holding company and receive, after that reorganization, substantially the same proportional share interests in the bank holding company as they held in the bank, except for changes in shareholders' interests resulting from the exercise of dissenting shareholders' rights under State or Federal law.".

SECTION 6. FARMER MAC.

(a) Lending Limit. Section 5200 of the Revised Statutes (12 U.S.C. 84) is amended by adding the following new paragraph at the end of subsection (c):

"(11) That portion of a loan sold on a non-recourse basis into a loan pool guaranteed by the Federal Agricultural Mortgage Corporation (established pursuant to title VII of the Agricultural Credit Act of 1987, 12 U.S.C. 2279aa) shall not be subject to any limitation based on capital and surplus regardless of how credit risk is allocated between seller and purchaser."

(b) Capital. That portion of a loan s[illegible]y a bank on a non-recourse basis into a loan pool guaranteed by the Federal Agricultural Mor[illegible]ge Corporation (established pursuant to title VII of the Agricultural Credit Act of 1987, 12 U.S.C. 2279aa) shall not be counted as an asset by any Federal banking regulatory agency for the purposes of calculating a bank's capital requirements.

SECTION 7. BANKERS' BANKS.

(a) Bank Holding Companies. Paragraph Seventh of section 5136 of the Revised Statutes (12 U.S.C. 24) is amended by inserting "or their holding companies" immediately following --

(1) "is owned exclusively (except to the extent directors qualifying shares are required by law) by depository institutions", and

(2) "providing services for other depository institutions".

(b) Section 5169 of the Revised Statutes (12 U.S.C. 27) is amended by inserting --

(1) ",directly or through a holding company," immediately following "which is owned", and

(2) "or their holding companies" immediately following "other depository institutions" each place it appears in paragraph (b)(1).

(c) Technical Amendment on Bankers' Banks and Deposit Insurance. -- Section 3(e) of the Bank Holding Company Act of 1956 (12 U.S.C. 1842(e)) is amended by striking "bank described in the last sentence of section 2(c)" and inserting "a bankers' bank as described in section 5169 of the Revised Statutes (12 U.S.C. 27)".

(d) Limit on Loans Secured by Securities. -- Section 11(m) of the Federal Reserve Act (12 U.S.C. 248(m) is amended by striking out "10 percentum" in each place it appears and inserting in lieu thereof "15 percent".

SECTION 8. PAPERWORK REDUCTION.

(a) Regulatory Flexibility Amendment, Elimination of Waiver. The Regulatory Flexibility Act (12 U.S.C. 601 et seq.) is amended by --

(1) striking out subsection 605(b) and redesignating the following subsection accordingly; and

(2) striking out "Except as provided in section 605(b), an" in subsection 608(b) and inserting in lieu thereof "An".

(b) Home Mortgage Disclosure Act Exemption. --

(1) Section 309 of the Home Mortgage Disclosure Act of 1975 (12 U.S.C. 2808) is amended by --

(A) striking out "$10,000,000" and inserting in lieu thereof "$50,000,000";

(B) adding the following new sentence at the end thereof --

"The figure in the preceding sentence shall be increased on January 1 of each year by the annual percentage increase in the Consumer Price Index reported the previous June 1."; and

(C) striking out subsection 304(i) (12 U.S.C. 2803(i).

Independent Bankers Association of America

IBAA

In Response to the Bush Administration's
Request For Comments

February, 1990

PROTECTING THE FEDERAL DEPOSIT INSURANCE SYSTEM

IBAA
INDEPENDENT BANKERS
ASSOCIATION OF AMERICA

Submitted pursuant to the Financial Institutions Reform,
Recovery, and Enforcement Act of 1989 (FIRREA)

TABLE OF CONTENTS

Part I. EXECUTIVE SUMMARY

- **A. Major Policy Recommendations** 5
- **B. Executive Summary** 7

Part II. FEDERAL DEPOSIT INSURANCE SYSTEM ISSUES

A. Purpose and History of Federal Deposit Insurance

1. Origins and Purposes of Insurance Funds

- a. Historical Background 13
- b. The $100,000 Coverage Level 19

2. Deposit Insurance and the Safety Net

- a. Scope of the Safety Net 20
- b. Too Big To Fail 21

B. Monitoring and Measuring Risk

1. Audit and On-Site Examinations

- a. Auditor-Regulator Relationship 25
- b. England's Banking Act of 1987 28
- 2. Market Value Accounting 35
- 3. Risk-Management Techniques. 38

C. Incentives to Control Risk

- 1. Scope of Deposit Insurance Coverage 41
- 2. Risk-based Premiums 47
- 3. Capital Adequacy 48

4. Optimal Fund Reserve Level

- a. Broadening the Base 50
- b. The Optimal Level 52

Part III. CLOSURE OR RECAPITLIZATION OF INSOLVENT, OR NEARLY INSOLVENT, INSTITUTIONS

A. Closure or Recapitalization Policies 55

B. Alternative Federal Deposit Insurance Systems 57

C. Modifying the Insurance Base

1. Assessment of Foreign Deposits 59
2. Assessment of Non-Deposit Liabilities 62
3. Multiple Insured Accounts 64
4. Limits on Brokered Deposits 64

D. Credit Unions

1. Capital Adequacy 67
2. Common Bond Erosion and Lending Limits 71
3. Separating the Chartering Function from the Insurance Function 72

E. Interrelationships of Regulation, Federal Deposit Insurance, and Financial Activities

1. Evolution of Interrelationship 75
2. Current Interrelationships 80
3. Appropriate Interrelationship for the Future 81

Part IV. APPENDICES

A. Tables

1. Consumer Attitude Toward Safety of Savings in Large Vs. Small Institution (Region, Race, Education, Employment Data)
2. Consumer Attitude Toward Safety of Savings In Large Vs. Small Institution (Sex, Age, Income, Marital Status Data)
3. Federal Insurance Limits Which Would Change Savings Behavior
4. How Limit Reduction Would Change How Much or Where One Saves
5. Bank Insurance Fund Reserves: Only Domestic Deposits Assessed
6. Bank Insurance Fund Reserves: Domestic and Foreign Deposits and Non-deposit Liabilities Assessed
7. Projected Income From Foreign Deposit Assessment
8. BIF Assessment Income From Domestic and Foreign Deposits and Non-Deposit Liabilities of the 30 Largest Commercial Banks
9. Potential Income to the Bank Insurance Fund from the 30 Largest Commercial Banks

B. Footnotes

C. Bibliography

D. Study of Consumer Reaction to Changes in Federal Deposit Insurance

E. Study of Private Insurance

F. Capital Definitions

G. Treasury Department's Request for Comments on the Federal Deposit Insurance System

3 - 4

Part I. EXECUTIVE SUMMARY

A: MAJOR POLICY RECOMMENDATIONS

Deposit Insurance Coverage -- Too Big to Fail and the Deposit Insurance Safety Net:	Depositors in large insured institutions have not been exposed to loss and it is highly unlikely that they will ever be put at risk. Under this policy, adopted to insure financial stability, government agencies ignore the $100,000 insurance limit and protect all of the deposit liabilities of the nation's major banks. Recognizing this fact, the IBAA urges that all depository institutions, regardless of size, be granted the full deposit insurance coverage enjoyed by too-big-to-fail banks.
Increase Reserves of Insurance Fund:	The IBAA strongly recommends that the BIF be maintained at 1.25% of all its contingent liabilities, namely all domestic deposits, foreign deposits, and non-deposit liabilities. A sound banking system requires investment to adequately fund the safety net.
Protect the Fund:	This larger fund--which will continue to be funded by commercial bank premiums--must not be misappropriated to pay for problems in the savings and loan industry.
Assess All Liabilities:	The IBAA recommends that exposure to the insurance fund associated with foreign deposits and non-deposit liabilities be acknowledged and that they be assessed.
Increase the Capital Base:	The proposed minimum leverage rate of 3 percent Tier I Capital to total assets is too low and invites risks to the insurance fund that could be mitigated were a tougher standard adopted. The IBAA recommends that the minimum leverage ratio be set above 4 percent.
Do Not Shift Risk of Loss to the Depositor:	The IBAA opposes any plan that asks depositors to impose "market discipline" by monitoring the health of their banks.
Private Insurance is Not Available:	Based upon an independent assessment conducted for the IBAA, it appears that the private insurance alternative is not presently viable, and if were ever implemented, many small banks could not get coverage.
Do Not Extend Mark-to-Market Accounting:	The IBAA is adamantly opposed to extending mark-to-market accounting requirements to additional elements of the banks' balance sheets.
Do Not Rely on Firewalls to Contain Risk:	We are very skeptical that corporate "firewalls" erected to segregate new risky activities from insured depository institutions in a bank holding company structure will prove reliable barriers in a crisis. Banks can, however, safely offer consumer services such as retail brokerage of insurance, securities and real estate.
Apply Equal Regulatory Treatment to Credit Unions:	Credit unions have many of the powers of banks but are not subject to the same regulatory restrictions. This must be corrected.
Reject Audit Provisions of England's Banking	The provisions of the Act, if applied in the U.S., are impractical, unnecessary, redundant, and transgress the authority of the banks' management and boards.

B. EXECUTIVE SUMMARY

The IBAA Perspective

The Independent Bankers Association of America (IBAA) represents the viewpoint of thousands of community banks serving the financial needs of local depositors and businesses across the land. Our membership alone numbers approximately 6300 banks that are independently owned and locally operated to serve their communities. Our member banks are typically small, with approximately 90% having less than $100 million in assets. Their communities depend upon these banks to provide a safe, easily accessed depository for savings, and to serve the credit needs of the consumers, small businesses, farmers, and ranchers. The vitality of those customers is fundamental to the economic well-being of their communities.

These comments reflect the convictions of our constituents - a group that represents 50% of all Federally insured banks in the country. It is these institutions that would bear the brunt of any deposit insurance reform proposals.

Background

For more than fifty years the government, through federal deposit insurance, has actively supported the position that all areas of the nation should have access to credit, and that an extensive network of community financial institutions is essential to the financial system. The soundness and stability of the financial system is of utmost priority, since it is depositors who provide the funds that become the credit that sustains local economies and regional development.

In the 1930's a loss of confidence among depositors precipitated a banking crisis and prompted Congress to establish deposit insurance and reform bank regulation. Deposit flows to community banks resumed as these measures restored faith in the banking system. Now, fundamental changes in deposit insurance are being considered by the government for the first time in fifty years.

The U.S. Department of the Treasury has requested comments on a variety of topics, including:

- What liabilities represent potential exposure for the deposit insurance fund?
- How large a fund is adequate and how should premiums be assessed?
- Should part of the potential liability be shifted to the depositor by reducing insurance coverage?

In presenting our comments, we are committed to the preservation of a sound financial system, the protection of small depositors' savings, access to credit for the small businessperson, and the continuation of a strong community bank network to serve financial needs across the nation. The IBAA analysis and comments, organized for each of Treasury's topics as presented in the Federal Register, December 6, 1989, are included. Our position on several key issues is summarized below:

Acknowledge the Impact of The "Too-Big-To-Fail"

We agree with the view of FDIC Chairman L. William Seidman and other top regulatory officials that depositors in large insured institutions have not been exposed to loss and it is highly unlikely that they will be put at risk. Under this policy, adopted to ensure continued financial stability, government agencies ignore the $100,000 insurance limit and protect all of the liabilities of the nation's major banks. If they did not it would be infinitely more difficult to stabilize the deposit base of a major depository institution that was being bailed out. Stabilizing these deposits has been necessary to prevent the collapse of the national and international financial system in times of stress.

Acknowledging this policy reality leads the IBAA to three conclusions:

- All depository institutions, regardless of size, must be granted the full deposit insurance coverage enjoyed by the too-big-to-fail banks.
- The deposit insurance fund must acknowledge all of its potential liabilities and its reserves must be increased to adequately meet its responsibilities.
- All of the liabilities of the nation's banks, including foreign deposits and non-deposit liabilities, must be included in the deposit insurance assessment base.

Apply the Safety Net Equally

While depositors in the too-big-to-fail banks have benefitted from 100% coverage for all forms of deposits, depositors in smaller banks have often been subjected to a strict interpretation of the insurance fund provisions. In these cases, only domestic deposits up to the $100,000 limit have been covered. The intent of the safety net is to preserve confidence in the system by insuring depositors without regard to the size of their bank, yet this intent is being violated by the preferential treatment afforded depositors of large banks. This inequitable application of the safety net has created a competitive advantage for the large banks, and discriminates against small banks and their depositors. And, coupled with the high number of small bank failures in recent years, it has strengthened the linkage between insurance coverage and the flow of deposits.

The IBAA strongly contends that depositors should be treated equally at all institutions; they should all have 100% insurance coverage. Discriminatory levels of deposit insurance cannot be tolerated merely because a depositor is a customer of a smaller institution.

Increase Reserves of Insurance Fund

The deposit insurance program, along with the Federal Reserve discount window, has always been the one of the key elements of the safety net that underpins the safety and soundness of the financial system. As originally conceived, the banking industry would fund an insurance pool, administered by the FDIC, with the adequacy of the fund being measured against the insured liability, specifically domestic deposits less than a specified amount, now $100,000. Domestic deposits over $100,000, non-deposit liabilities, and foreign deposits are not considered in determining the adequacy of the pool, since they are not insured -- and technically should present no liability to the fund.

However, recent events have established beyond argument that these liabilities, concentrated in the too-big-to-fail banks, are indeed de facto contingent Bank Insurance Fund (BIF) liabilities. Assertions that BIF can fulfill its function as the safety net without recognizing and funding for its actual risk ignores the realities.

The IBAA strongly recommends that the BIF be maintained at 1.25% of all its contingent liabilities, namely all domestic deposits, foreign deposits, and non-deposit liabilities. A sound banking system requires investment to adequately fund the safety net and we are committed to that objective, even though rebates to the community banks will be delayed for approximately three years.

This larger fund -- which will continue to be funded by commercial bank premiums -- must not be misappropriated to pay for problems in the savings and loan industry. It would be inappropriate, and it would be unwise to divert resources which may be needed to stabilize the financial system in the future.

Assess All Liabilities

The liabilities currently assessed to fund the insurance reserves are limited to domestic deposits. It is time to accept the fact that the liabilities representing exposure to the insurance fund include foreign deposits and non-deposit liabilities. These liabilities, though not technically covered by deposit insurance or assessed, have been protected at too-big-to-fail banks, such as Continental Illinois and First Republic Bank, in effect granting 100% coverage to all forms of deposit. These actions, taken to avoid a crisis, prompted the public perception that certain banks are too-big-to-fail, and that all deposits would be protected at large banks.

The IBAA strongly contends that the potential impact on the insurance fund is greatest from these too-big-to-fail banks. For the eleven largest banks having assets greater than $30 billion, only 36% of their assets are funded by assessable deposits. In contrast, approximately 10,500 banks having assets of less than $100 million fund over 88% of their assets with assessable deposits. Assessing foreign deposits and non-deposit liabilities would eliminate the inequity of providing 100% deposit coverage for the too-big-to-fail banks that currently are assessed on a fraction of their deposit risk. The IBAA recommends that exposure to the insurance fund associated with foreign deposits and non-deposit liabilities be acknowledged and reflected in the premiums paid by large banks.

Increase the Capital Base

The IBAA believes that capital adequacy is fundamental to a sound financial system, and we acknowledge that the insurance fund is best protected from risk by an insured institution's equity capital. We have previously endorsed the risk-based capital framework. We suggested, however, an adequate phase-in period during which the existing capital ratios would be used in tandem with the risk-adjusted ratio to allow the industry and the regulators to gain experience.

The proposed minimum leverage rate of 3 percent Tier I Capital to total assets, effective December 31, 1990, is too low and invites risks to the insurance fund that could be mitigated were a tougher standard adopted.

Recognizing the Tier I Capital excludes loan loss reserves, the IBAA recommends that the minimum leverage ratio be set above 4 percent. Such a policy shifts a portion of the risk from the insurance fund to the banks' shareholders who through their elected boards of directors have control over the degree of risk taken by the bank.

Do Not Shift Risk of Loss to the Depositor

The IBAA commissioned a survey of consumers to test their reactions to revisions to the $100,000 deposit insurance level. If depositors were limited to one account per institution, or if the amount insured were reduced, depositors indicated they would redistribute their savings to more institutions, or shift them to a large bank which was perceived as too-big-to-fail. In either of these events, the aggregate potential exposure to the insurance fund would not be diminished. The true impact would be to disrupt traditional or normal deposit gathering with an attendant increase in operating expense, since the number of accounts would increase while the aggregate deposits remained the same. The IBAA opposes any scheme that exposes depositors to risk of loss and asks them to impose "market discipline" by monitoring the health of their banks. We agree with Chairman Seidman that depositors cannot do this.

Private Insurance Is Not Available

Based upon an independent assessment conducted for the IBAA, it appears unlikely that the insurance industry will assume a meaningful role in deposit insurance. Some major concerns that would preclude any meaningful role for the private sector include:

- uneven supervision and enforcement by the regulatory agencies
- limited access to qualitative data on the condition of a bank
- lack of timely and accurate data on changes in condition
- lack of control over assets to mitigate claims expense
- protection of uninsured deposits at too-big-to-fail banks.

If the private sector were to participate at all, its coverage would not be universally available. The expense associated with underwriting and monitoring coverage would not be justified by the premium income from small banks. Given the risk and the administrative cost, the insurance carrier could not make a profit and small banks could not get coverage.

The IBAA believes that the private insurance alternative is not viable, since if implemented at all, it will not be available to the vast majority of banks.

Do Not Extend Mark-to-Market Accounting

The IBAA is adamantly opposed to extending mark-to-market accounting requirements to additional elements of the banks' balance sheets. Imposition of broader mark-to-market requirements ignores the going concern value of a bank, is likely to drain liquidity from the system, and would provoke changes in portfolio management that would hamper community banks' ability to serve the needs of local businesses. Reliable indices of value, such as active secondary markets, simply do not exist for many assets commonly held by community banks. Estimates of value for such assets would be highly subjective, grossly inconsistent, and costly to determine. Such costs would present a hardship to community banks.

Do Not Rely on Firewalls to Contain Risk

The IBAA believes that the highest priority of the policy makers should be preserving the safety and soundness of the financial system. Opportunities for diversification into new activities include elements of risk that must be scrutinized closely to assess potential adverse consequences for the stability of the system. In times of crisis, such as we have seen with too-big-to-fail banks, risks have not been contained within proscribed or expected bounds. Likewise, we are very skeptical that corporate "firewalls" erected to segregate new risky activities from insured depository institutions in a bank holding company structure will prove reliable barriers in a crisis.

Banks can, however, safely offer consumer services such as retail brokerage of insurance, securities and real estate.

Apply Equal Regulatory Treatment to Credit Unions

Credit unions have many of the powers of banks but are not subject to the same regulatory restrictions. This must be corrected.

For example, credit unions should not be permitted to treat the one percent of shares deposited with NCUSIF as an asset. The practice presents a false picture of solvency in the credit union industry by overstating its capital strength. The one percent of shares deposited with NCUSIF is at risk, especially in times of crisis. Were these funds used by NCUSIF, the credit unions would be forced to take an immediate writedown, probably at a difficult time for the industry, when it could least afford to sustain additional losses to capital. Credit unions should be required to expense the one percent.

Credit unions have applied increasingly liberal interpretations of the common bond test, allowing them to expand their membership beyond that originally intended in state and federal statutes. Credit unions not adhering to a strict interpretation of the common bond test should be required to convert to commercial bank charters.

NCUA currently is responsible for both the chartering and insuring functions. The inherent conflict between the promotion of credit unions - the chartering function - and the supervisory role associated with the insurance function, should be acknowledged and the functions should be separated.

Reject Audit Provisions of England's Banking Act

The Act imposes regulatory requirements, including mandatory full independent audits, and authorizes direct communication between private auditors and the regulatory agencies. In general, the provisions of the Act, if applied in the U.S., are impractical, unnecessary, redundant, and transgress the authority of the banks' management and boards.

We do not believe it is feasible for qualified CPA firms to complete full audits for the nearly 13,000 U.S. commercial banks each year. By contrast, the English banking system is comprised of only approximately 300 very large banks which must undergo full audits. In the U.S. the expense and hardship for a small rural banks of importing a qualified CPA firm would be unreasonable.

Adoption of the audit provisions of England's Banking Act is not necessary. Rather, the examination process should be upgraded by providing better training for examiners and by reducing turnover among field examiners. The IBAA supports internships at commercial banks as a valuable training opportunity for field examiners which will help them develop the judgment needed to be effective examiners.

Part II. FEDERAL DEPOSIT INSURANCE SYSTEM ISSUES

A. PURPOSE AND HISTORY OF FEDERAL DEPOSIT INSURANCE

1. Origins and Purposes of Insurance Funds

The first aspect that commenters are asked to consider in the study of the federal deposit insurance system is its history. **From its establishment during the days of financial crisis in the 1930s, deposit insurance has become an integral component of our financial system. Without it our financial system would not function efficiently and consumer confidence would be seriously weakened. The goals of deposit insurance remain unchanged--to protect the deposits of consumers and small businesses, which ultimately protects the funding flows to small banks.**

a. Historical Background

The states were the first to venture into establishing deposit insurance programs, the first being introduced in New York in 1829 by Governor Martin Van Buren. 1/ From 1829 to 1917, 14 states established deposit insurance programs for their state-chartered banks. These programs were established to protect communities from the economic disruptions caused by bank failures and to protect depositors against losses.

While the states took the lead, there were also members of Congress who were interested in a federal deposit insurance system. The first bill was introduced in 1866. 2/ From 1886 until the establishment of the Federal Deposit Insurance Corporation in 1933, 150 proposals for deposit insurance or deposit guaranties were introduced in Congress. 3/

The stock market crash of 1929, and the ensuing banking crisis in the early 1930s, provided the impetus for Congress to create a system of federal deposit insurance. In the four years after the crash, about 9,000 banks closed, resulting in losses to depositors of more than $1.3 billion. 4/ Most of the bank closings in the 1920s were in agricultural areas. However, in 1930, larger urban banks also began to fail.

The Hoover Administration and Congress responded in two ways. First, the Reconstruction Finance Corporation (RFC) was created in January 1932. By the end of that year, the RFC had authorized almost $900 million in loans to troubled banks. Second, Congress broadened the circumstances under which member banks could borrow from the Federal Reserve.

Financial conditions deteriorated further during the winter of 1932-33. By March 4, 1933, the date of President Roosevelt's inauguration, every state in the union had declared a bank holiday. One of Roosevelt's first official acts was to declare a nationwide bank holiday to begin on March 6th. 5/ Congress responded by passing the Emergency Banking Act, which legalized the bank holiday and set standards for reopening nationally-chartered banks. Having passed the emergency legislation, Congress then turned its attention to the issue of deposit insurance. 6/

The House of Representatives had passed a deposit insurance bill in 1932, but the Senate adjourned without acting on it. 7/ The chief proponent of federal deposit insurance was House Banking Committee Chairman Henry B. Steagall (D-Ala.), who faced strong opposition from the Roosevelt Administration, most of the large banks, and Chairman Carter Glass (D-Va.) of the Senate Banking Committee. 8/

Arguments against federal deposit insurance included the failures of state deposit insurance programs, that it would remove penalties for bad management, and that it would be too expensive and an unwise intrusion by the federal government into the private sector. Large banks in particular were opposed to deposit insurance. However, small banks were very supportive of the federal deposit insurance program since it was thought that federal deposit insurance would enable small banks to secure deposit inflows.

In May of 1933, both Senator Glass and Congressman Steagall introduced bills including deposit insurance provisions. Senator Glass apparently yielded to public opinion in favor of deposit insurance. After a short but heated conference, a compromise was reached, with the House conferees essentially conceding the two controversial provisions of the Senate bill. These provisions required Federal Reserve System membership for insured banks and made deposit insurance a temporary program. 9/ Both Houses passed the conference report on June 13, 1933; President Roosevelt signed the bill on June 16, 1933. 10/

The 1933 Act created two separate deposit insurance plans under the new Federal Deposit Insurance Corporation: a temporary plan to become effective on January 1, 1934; and a permanent plan to take effect on July 1, 1934. 11/ Capital to establish the FDIC came from the Treasury and the 12 Federal Reserve Banks. Treasury contributed $150 million, and each of the Reserve Banks was required to buy stock in an amount equal to half of its surplus as of January 1, 1933. 12/

The temporary plan limited deposit insurance protection to $2,500 for each depositor. 13/ Banks admitted to the plan were to be assessed an amount equal to one-half of one percent of insurable deposits. 14/

The original permanent plan in the 1933 Act never took effect but was replaced by a new permanent plan in the Banking Act of 1935. The original permanent plan called for full protection of the first $10,000 of deposits, 75 percent coverage of the next $40,000 and 50 percent coverage of all deposits in excess of $50,000. The original permanent plan also subjected banks to whatever assessments were necessary to meet losses from deposit insurance operations.

Actual insurance of bank deposits became effective on January 1, 1934. Congress postponed the effective date of the permanent plan to July 1, 1935 and increased the protection from $2,500 to $5,000 per depositor, effective July 1, 1934. Hearings on the new FDIC continued in February 1935 and focused on the FDIC's assessment powers and the requirement of Federal Reserve membership.

In August, Congress passed the Banking Act of 1935, which adjusted the annual assessment rate to one-twelfth of one percent on total deposits and required Fed membership as a precondition of insurance only for banks with more than $1 million in deposits. 15/ The Fed membership requirement was eliminated entirely in 1939. The Banking Act also continued the coverage of $5,000 per account, rather than the increased sliding scale version of the "original" permanent plan. 16/ The $5,000 per account limit was raised to $10,000 in 1950, increased to $15,000 in 1966, to $20,000 in 1969, to $40,000 in 1974 and to $100,000 in 1980. 17/

With respect to the 1935 Act, Congressman Steagall said:

> ... the purpose of this legislation is to protect the people of the United States in the right to have banks in which their deposits will be safe. They have a right to expect of Congress the establishment and maintenance of a system of banks in the United States where citizens may place their hard earnings with reasonable expectation of being able to get them out again upon demand.... This bill seeks to establish a mutual insurance system supported and maintained by the banks themselves, in their

> own interests as well as for the benefit of their depositors.... We cannot have a normal use of bank credit in the United States until people are willing to put their deposits in banks. Deposits constitute the basis for bank credit, and bankers can never be free to extend credit accommodations for the support of trade and commerce until they are permitted to retire at night without fear of mobs at their doors the next morning demanding cash for their deposits. 18/

President Roosevelt and Senate Banking Committee Chairman Glass both initially opposed federal deposit insurance. Roosevelt felt that the use of tax revenues to finance such a system was unacceptable. However, because of the weakened condition of the banking industry, he recognized that at least some of the initial capitalization would have to come from government sources.

During Senate debate, Senator Glass repeatedly emphasized that this was to be an insurance fund but not a government guarantee. He stated:

> I am not standing here as an advocate. For 35 years in the other House, and up to this time in the Senate, I have opposed guaranteeing deposits, but this is not a Government guaranty of deposits.... The Government is only involved in an initial subscription to the capital of a corporation that we think will pay a dividend to the Government on its investment. It is not a Government guaranty. 19/

(The Congress has since made clear that the federal government stands behind the deposit insurance system.)

Deposit Insurance for Thrifts

Savings and loan associations were quickly brought under the deposit insurance system. In a statement to the Senate Banking Committee on May 16, 1934, Bank Board Chairman John Fahey argued that establishment of the Federal Savings and Loan Insurance Corporation was a matter of equity for thrifts:

> The building and loan associations... situation has been impaired progressively by the developments of the last few months. The savings banks and the savings departments of

> the commercial banks have come under the provisions of the deposit-insurance act. There is no corresponding protection for the building and loan associations, cooperative banks, and the so-called "homestead associations."
>
> The result is that as shares mature the savers withdraw their money, and it is proven conclusively that they invariably take their checks to the savings departments of the commercial banks or to the mutual savings banks, and the money goes into those institutions.... It is for this reason that our Board has recommended a mortgage-insurance plan for the cooperative banks and the building and loan associations. 20/

The threat to thrifts was not deposit losses, but rather that a lack of public confidence which might prevent an adequate inflow of new funds to maintain home lending activities. The differences at the time between bank and thrift charters supports the argument that the creation of FSLIC was more related to housing policy than monetary or economic policy. 21/

The thrift industry initially resisted deposit insurance. Federally chartered thrifts were required to carry it, but coverage was optional for state chartered thrifts, most of which refused to sign up. 22/ It was not until 1951 that FSLIC-insured thrifts outnumbered non-FSLIC-insured thrifts.

Under the 1934 Act, savings accounts in FSLIC-insured thrifts were guaranteed up to $5,000. 23/ The 1934 Act established the FSLIC premium rate at one-fourth of one percent of total deposits. That Act also established a special assessment, also at the one-fourth of one percent rate. Both assessments were reduced to one-eighth of one percent in 1935. In 1950, the regular premium was reduced to 1/12 of one percent. 24/ More recently, the regular FSLIC premium was 1/12 of one percent, while the special premium was 1/8 of one percent. Although on the books since 1934, the special assessment was not imposed by FSLIC until 1985. The 1/8 of one percent was levied quarterly from 1985 through 1989.

FSLIC insurance limits have increased concurrently with those of FDIC insurance, from $5,000 in 1934 to $100,000 in 1980. 25/

Deposit Insurance for Credit Unions

The National Credit Union Share Insurance Fund (NCUSIF) was created by Title II of the Federal Credit Union Act, signed into law by President Nixon on October 19, 1970. 26/ Prior to 1970, share accounts in federal credit unions were uninsured and many credit unions, federal and state, opposed any type of federal insurance, fearing the regulation that would accompany it.

Unlike the FDIC and FSLIC, the creation of NCUSIF was not the result of an economic crisis. Rather, Congress saw the growth of credit union deposits and sought to "reward" the industry with deposit insurance. The House Committee Report on the 1970 Act states:

> Credit unions are the only federally chartered financial institutions that do not have a Federal program of savings or deposit insurance. Despite the lack of insurance, credit unions have grown to a point where there are now more credit unions than all other financial institutions combined.... Your committee wishes to make it clear that this legislation is designed solely to give credit unions the same insurance afforded other federally chartered financial institutions and should be considered as a reward for the outstanding job performed by credit unions. The legislation in no way is intended to indicate that credit unions are facing a period of monetary difficulty. On the contrary, your committee feels that credit unions are in perhaps their strongest financial condition in history. 27/

The legislation set the annual premium at 1/12 of 1 percent. The legislation contained no provision for original capitalization or funding of the insurance fund. 28/ For over a decade, the insurance fund was built up only through premium assessments. In the early 1980s, due to increased credit union growth and insurance losses, the NCUSIF required recapitalization.

Under the Deficit Reduction Act of 1984, insured credit unions are required to deposit into the fund an amount equal to 1/12 of 1 percent of their insured shares as of December 31 of each year, adjusted annually for credit union growth. The National Credit Union Administration (NCUA) still has authority to assess the 1/12 of 1 percent premium, but has waived the premium for 1986, 1987, 1988, 1989, and 1990.

Share insurance is presently at $100,000, the same as the FDIC/BIF and FDIC/SAIF coverage.

b. The $100,000 Coverage Level

In 1972, the Congress increased deposit insurance coverage to $40,000 to account for inflation. This was done over the objections of the House, which felt that the coverage should be increased to $50,000 if inflation were to be properly accounted for. 29/ In the historic Depository Institutions Deregulation and Monetary Control Act of 1980, deposit insurance coverage was raised to $100,000. In the legislative history of this increase, FDIC Chairman Sprague said that "his enthusiasm for increasing the figures is in direct proportion to your (Chairman St Germain) enthusiasm for doing something about the assessment refund ... you get up to $100,000, if that were coupled with a real change in the assessment rate, we wouldn't find it objectionable." 30/ During the House-Senate Conference on the Act, the FDIC supported increasing the insurance level.

One reason for increasing the coverage to $100,000 was the competition for deposits, particularly from the money market mutual fund industry, which had grown from zero to $250 billion in two years. Comptroller of the Currency Heimann noted that while money market funds were not insured, they offered very competitive rates and significant sums of money were flowing out of financial institutions. The level of deposit insurance, be it $40,000, $60,000, or $100,000, provided a depositor with protection not available in the money market fund. 31/

The FDIC noted in its history of deposit insurance that the increase to $100,000 was in recognition that many banks and thrifts, facing disintermediation in a high interest rate climate, had sizable amounts of large outstanding certificates of deposit and the new limit facilitated retention of these deposits in an environment free of interest rate ceilings. 32/

In late 1981, Senate Banking Committee Chairman Jake Garn proposed that deposit insurance levels be increased to $250,000, a proposal which then-Treasury Secretary Donald Regan opposed. 33/

2. Deposit Insurance and the Safety Net

a. Scope of the Safety Net

As of December 31, 1988, there were $2.9 trillion of federally insured deposits in depository institutions. Sixty-one percent were in commercial banks, 33 percent in S&Ls, and 6 percent in credit unions. 34/

Federally insured institutions as of 12/31/88

Commercial Banks & Mutual Savings Banks	13,631
S&Ls	2,949
Credit Unions	14,037
Total	30,620

In addition to insured deposits in these institutions, there are substantial liabilities that -- as is shown in the next section -- are fully covered by deposit insurance but are not assessed. Banks under $100 million in assets (some 10,500 institutions) fund over 88 percent of those assets with deposits subject to insurance assessments. In contrast, banks with over $30 billion in assets (11 banks which are clearly considered too big to fail) fund only 38 percent of their assets with assessable deposits. 35/ In addition, these larger banks present a systemic risk to the deposit insurance system which smaller banks do not. However, they are not paying either for the coverage they receive or to compensate for the systemic risk they present.

According to a 1986 GAO study, about 17 percent of premiums collected represented premiums on uninsured deposits, that is, on account balances in excess of $100,000, almost all of which were in commercial banks. 36/ As of June 1989, the FDIC reported that deposit accounts with balances of less than $100,000 represented 64 percent or $1.37 trillion of insured deposits while accounts with balances greater than $100,000 represented approximately 36 percent or $763 billion. Small banks (under $1 billion in assets) are paying premiums on 99 percent of their total deposits, while large banks (over $1 billion in assets) are subject to premiums on only 80 percent of their total deposits base.

Historically, the insurance funds have tried to maintain a coverage ratio of approximately one percent of insured deposits. The losses in the thrift and banking industries have significantly reduced this coverage level. In 1982, both Houses of Congress adopted House Concurrent Resolution 290 expressing their sense that the full faith and credit of the U.S. government stands behind all the deposit insurance funds. The resolution read:

> Whereas, since the 1930s, the American people have relied upon Federal deposit insurance to ensure the safety and security of their funds in federally insured depository institutions; and
> Whereas the security of such funds is an essential element of the American financial system;
> Now, therefore, be it Resolved by the House of Representatives (the Senate concurring), that the Congress reaffirms that deposits up to the statutorily prescribed amount, in federally insured depository institutions are backed by the full faith and credit of the United States. 37/

This technically non-binding resolution was reaffirmed by the Congress in the Competitive Equality Banking Act (CEBA) of 1987, which expressed the "sense of Congress" that all deposits up to the statutory limit "are backed by the full faith and credit of the Unites States." (CEBA, section 901(b)) 38/ Finally, the Federal Financial Institutions Reform, Recovery and Enforcement Act (FIRREA) of 1989 directs savings and loan associations and authorizes banks to display a sign stating that "insured deposits are backed by the full faith and credit of the United States Government." 39/

b. Too Big to Fail

The role of deposit insurance has expanded in recent years. Deposit insurance has been transformed from its original role as a safety net for small depositors to defending virtually all depositors in the very large institutions. 40/ This protection was made explicit when the Continental Illinois National Bank and Trust Company failed in 1984 and all deposits--including those holding foreign deposits and depositors with deposits of more than $100,000--were honored. 41/ Commenting on this extraordinary rescue, then Comptroller of the Currency D. Todd Conover, in publicly recognizing that the largest U.S. banks were too big to fail, told Congress that:

> ... had Continental failed and been treated in a way in which depositors and creditors

> were not made whole, we could very well have seen a national, if not an international financial crisis the dimensions of which were difficult to imagine. 42/

A more recent example of 100 percent depositor protection is the failure of the First Republic Bank in Texas. In this instance, the FDIC sent a letter to the chairman of the failed bank stating:

> ... to assure _all_ depositors of the banks, insured and _uninsured_, and _all_ general creditors of the banks, that valid and enforceable obligations of the banks will be fully honored, regardless of the nature of the long range solution that may be announced.... 43/ (emphasis added)

Chairman Fronterhouse was also invited to share this letter with customers and depositors. However, the protection of all depositors has only been made available to large banks and savings and loan associations. Large banks enjoy the privilege of being too-big-to-fail, but small banks and thrifts do not have this protection. Neither do their depositors. So long as depositors at larger institutions are not at risk in any way, equity demands that depositors at smaller institutions also not be at any risk. Smaller institutions don't present any systemic risk to the overall deposit insurance system.

Reducing statutory deposit insurance levels in the too-big-to-fail policy context would create funding problems for smaller institutions and cause depositors to move their funds to larger banks or thrifts.

The President of the Federal Reserve Bank of Minneapolis adressed this issue in the context of proposals to reduce federal deposit insurance coverage. He stated:

> All of the above arguments assume the policy of too-big-to-fail would be permantly dropped. If for some reason, the very large banks continue to receive total _de facto_ guarantees, their present competitive advantage would be perpetuated, and co-insurance would have no affect on the moral hazard problem with large banks. Indeed, that advantage would be even greater in the future because, for them, the co-insurance provisions would be effectively inoperative. 44/

Speaking before a conference organized by the Association of Reserve City Bankers in conjunction with Northwestern University on December 14, 1988, FDIC Chairman L. William Seidman asked the audience, "Why don't we experiment and allow the next $30 billion bank that fails to close and see what happens?" Answering his own hypothetical question, he stated:

> So far the bureaucrat with that kind of courage hasn't been born, and I don't think he will be born. So that's not going to happen with a major institution. Given that, what are you going to do about smaller institutions. Are you going to tell them, oh, your depositors are going to lose, but the big guy, no, they'll always be protected. 45/

In an earlier speech in November 1988, Chairman Seidman explained why altering the too-big-to-fail doctrine would cause major new public policy problems. Without this doctrine, a large bank failure could destabilize the entire international financial system, with the U.S. becoming the only industrialized nation not to stand behind its major banks. 46/ Chairman Seidman, again in a recent appearance before the House Banking Committee, stated that he does not see a way out of the too-big-to-fail situation:

> But, again, that will make it tougher for small banks as long as you are going to rescue big bank depositors, because you can't allow the big bank to fail because the effect on the system, and I think, you know, we are stuck. And one of the ways is to either develop a way that we can handle a big bank so that if it fails we can close it down and only pay off insured depositors.
>
> Frankly, we have looked at that. We have worked with big institutions, and at this point we haven't found any way justifiably to do that, so I would welcome, Mr. Chairman, hearings on this. 47/

The IBAA shares the conclusion that this government and no future government will permit a very large bank to fail. The effect such a decision could have on the confidence in the U.S. and world banking systems could be catastrophic and should not be risked. The safety and soundness of our financial system would be undermined by such policy action. Policy makers must, therefore, provide for full protection for all

depositors at all institutions at comparable rates when considering deposit insurance reform. Large institutions, which present a systemic risk to the insurance system, clearly enjoy 100 percent coverage. Equity demands that depositors at smaller institutions, who present no such systemic risk to the system, also enjoy 100 percent protection.

B. MONITORING AND MEASURING RISK

1. Audit and On-Site Examinations

a. Auditor-Regulator Relationship

Comments are requested on the benefits of a closer relationship between the auditors and regulators of depository institutions. First, the Treasury asks whether a financial institution's independent auditors and accountants should be required to report audit results directly to the appropriate regulator(s). Second, they ask whether regulators should share their reports and analyses of a depository institution with the institution's independent auditors. And third, they ask whether independent auditors and accountants should be required to participate in conferences between the regulator and the depository institution.

The IBAA is opposed to broadly permitting the direct interchange of information between independent auditors and regulators and to requiring that independent auditors and accountants be included in discussions between the depository institution and its regulators. The rights of financial institutions to due process must be restored. We believe due process is violated when regulators are given audit results without notice to the bank's management and board of directors and without providing an opportunity to react to, explain, or comment on the auditors' findings. Appropriate procedures require auditors to communicate first with the institution's board of directors. In any case, the financial institution's board of directors and management must be apprised of, consent to, and authorize any communication between its auditors and its regulators. All information appropriately should flow through the financial institution to its regulators or to its auditors.

Any direct communication between regulators and independent auditors encroaches on the duties of bank managers and violates the authority of the board of directors. The IBAA believes that submission of the audit report directly to the regulators would severely impair the board of directors' ability to analyze audit recommendations, to investigate any discrepancies and to make corrections. Direct communication between the financial institution's auditor and regulators would remove a significant step of management control that is rightfully the responsibility of the bank's board of directors and officers. Regulators should not be involved in the bank's daily operations and activities.

The FDIC recognized this when they amended the proposed statement of policy on external audits to provide time for review of the audit recommendations by the bank's board of directors before submission to the regulators regional office. 48/ The FDIC acknowledged that "... the board of directors ... is responsible for safeguarding the bank's assets and ensuring the integrity of its financial statements." 49/

Likewise, it is the responsibility of the bank to share its examination reports with its independent auditor. The information provided in an examination report is highly confidential. Independent auditors are consultants to the bank and, as such, are private employees of the bank. Both section 931 of FIRREA and the FDIC's guidance for state nonmember banks recognize this aspect of the financial institution's authority. 50/ The FDIC further recognized the bank's authority to determine the need for an independent audit by assuring that "... examiners will not automatically comment negatively upon a bank that does not have an audit.... "51/

Because independent auditors often are retained by banks for very specific purposes, for example, to satisfy the contract requirements for bonding or for directors and officers insurance, they are not necessarily qualified to judge the quality and ultimate value of a bank's assets. Auditors are accountants, and as such they analyze the quantitative financial statements and general operations of a bank. **It is not appropriate to put independent auditors in a de facto position of judging the safety and soundness of the bank or the risk the bank may cause the deposit insurance system.** If auditors were required to be proficient in all phases of bank analysis, fees for audit services would sky rocket. At the very least, such direct submissions of audit reports to regulators would imply, if not mandate, additional liability for the auditor and audit firm. Audit firms would charge banks for this additional responsibility and risk.

Since history has shown that positive reports from independent audits do not assure the viability of the financial institution, the value of certified audit reports is suspect. A General Accounting Office (GAO) study concluded that more than 54 percent (6 out of 11) of institutions studied had insufficient, inadequate or substandard audits conducted by outside certified public accountants (CPAs). 52/ **Independent auditors cannot substitute for impartial regulatory examiners that work for U.S. government agencies and represent the interests of the American public. Audit reports do not address the qualitative issues that affect the**

safety and soundness of the deposit insurance system. The IBAA opposes any decrease in the frequency or quality of regulatory bank examinations, which would have a negative impact on the safety and soundness of the banking system.

Community bankers are concerned that, if independent audits are required, only nationally recognized or specially certified firms would be qualified to complete and submit audit reports for financial institutions. Many small and/or remote communities do not have large, nationally recognized CPA or audit firms. Local accounting and bookkeeping firms, although skilled and qualified to do the tasks for which they are now hired, may not be qualified to perform a bank audit. The cost of hiring a nationally recognized firm would be astronomical for a bank in a remote community. Furthermore, the quality of local branches of large, nationally recognized, audit firms is not necessarily the same caliber as the firm's reputation nationwide.

Many community banks have established thorough controls and review processes using internal auditors and audit committees who report directly to the board of directors without the prior intermediation by any other bank officer or manager. Outside audits are very costly for community banks. **Since small banks do not pose a systemic risk to the deposit insurance fund, a balance must be struck between the need for controls and audits and the cost of utilizing outside firms for every audit procedure.** The U.S. Congress supported our position when they rejected the Roth amendment to FIRREA which would have required financial institutions to have independent public audits each year. 53/

Currently, financial institutions have the authority and freedom to choose from a variety of audit methods and service providers. Among others, they may have internal audits, engagement audits, operational audits, or directors examinations, and they may use outside directors, local accounting firms, licensed public accountants, or CPAs. If the submission of audit reports directly to regulators were to result in mandated use of certified public accounting firms in the name of quality control, the community bank's selection of service providers would be limited and CPA firms could gain unwarranted power and oligopolistic authority, especially in light of the significant number of mergers among large, nationally recognized accounting firms.

The IBAA agrees with the Treasury that audits can greatly contribute to the safety and soundness of a depository institution and, ultimately, our insured financial system. **However, in a private market environment, we see no benefit in dictating that privately retained auditors share confidential information with a third party, even if it is the institution's regulator.**

The FDIC's policy statement encourages state nonmember banks to engage independent auditors, recommends standard audit procedures, and requests banks to file copies of the auditors' reports with the FDIC. 54/ The IBAA believes that this policy statement protects the board of directors' management authority and allows management to make decisions which affect the bank's daily operations. In a similar manner, FIRREA requires bank management to share regulatory examination information with the auditors at the time of the audit. 55/ We see no benefit in direct communication between the bank's regulator and the bank's auditor.

b. England's Banking Act of 1987

Treasury requested comments on the feasibility of adopting regulations for the U.S. banking system similar to certain provisions of England's Banking Act of May 1987.

The IBAA opposes the adoption of regulations that are the same as, or similar to, the audit provisions of England's Banking Act. We do not believe that such regulations would enhance the safety and soundness of U.S. financial institutions.

England's Banking Act was designed for a country with just a few major banks. Similar laws would not be appropriate for the U.S.'s well diversified financial services industry. The U.S. accounting industry does not have the capacity to provide full certified audits for nearly 13,000 commercial banks each year.

> Section 8: Application for Authorization. The Bank of England may require a report by any accountant on any issues specified by the Bank regarding any person who is or is to be a director, controller or manager of the financial institution.

U.S. law currently provides sufficient authority to bank regulators to collect necessary information about parties controlling the institution at critical junctures in the bank's history. For example, before the Comptroller of the Currency may charter a national bank, the bank must have a board of directors who must own bank stock and must swear an oath to administer the affairs of the bank diligently and honestly and not to violate federal laws governing national banks. 56/ The Change in Bank Control Act requires persons acquiring control of a bank to prove to regulators that they have the necessary funds and expertise to acquire the institution. More recently, Section 914 of FIRREA requires new directors and senior officers of a new or troubled bank or thrift to obtain regulatory approval before assuming their posts. 57/

Since certified public accountants are not plentiful in remote or rural areas, their services are usually expensive. **Requiring an audit of every individual who is preparing to become a director or officer of a community bank would unfairly penalize smaller institutions, which would have more trouble affording, or even finding, a suitable accountant.**

In addition, regulators must assure that their investigative procedures 1) protect the individual's right to due process by assuring that he/she has the right to respond to and comment on the data required by the regulator, and 2) do not infringe upon the financial institution's authority to hire its staff and manage its activities. Because U.S. law already requires extensive disclosures from individuals assuming positions of control or responsibility in a bank, an independent audit would be redundant.

> Section 39: Power to Obtain Information and Require Production of Documents. Section 39(1)(b) gives the Bank of England, acting as regulator, the right to require any documentation it deems to be reasonably necessary to judge the qualification of the institution, including reports from auditors or other skilled professionals.

The IBAA is opposed to direct communication between the regulators and a bank's privately retained independent auditors. We believe this hinders the oversight activities of the financial institution's board of directors and circumvents its authority. Also, federal regulators already may obtain information from institutions in off-site examinations. We believe this gives regulators sufficient power to examine banks' "documentation" without giving them direct access to banks' confidential audits.

> Section 39(2): Accountants used by the financial institution must be approved by the regulator.

The IBAA generally opposes giving banking regulators the authority to approve financial institutions' accountants. We do not believe the banking regulators have the capacity to judge the qualifications of local audit firms or local branches of nationally recognized CPA firms. The accounting profession has a time-tested certification process and most states have strict licensing requirements, neither of which should be second guessed by banking regulators. In addition, it is the rightful responsibility of bank management and the board of directors to hire qualified staff, including outside audit firms or internal auditors.

The IBAA believes that requiring regulatory approval of accounting firms can only result in costly backlogs and extensive delays, which will, in the end, result in significant cost increases for accounting services. This provision would be costly for regulators to implement since a certification, revalidation or examination program would be required to assure quality compliance by the approved firms.

The IBAA strongly recommends that the banking regulators work with the accounting industry to facilitate the development of skilled professionals in the areas of accounting and audits for financial institutions.

> Section 39(6): The Bank of England may request any information it deems necessary about 1) the bank holding company, subsidiary or related company, 2) any holding company of the institution, 3) any holding company of any subsidiary of the institution, 4) any corporate body controlling more than 50 percent of the voting power and 5) any partnership to which the bank belonged.

The IBAA agrees that the activities of the owners of a bank, bank holding company, subsidiaries and other related companies may affect the viability of the bank operation. However, in the United States, this law could result in overlapping examination authority among the various banking regulators. It could undermine the dual banking system by giving any one regulator the authority to oversee the activities of all subsidiaries of bank holding companies and, thereby, restrict the role of the states as intrastate laboratories for the development of new banking-related products and services. **The existing separation of authority between**

different federal regulators, and between federal and state regulators, must be maintained to assure the continued success of the dual banking system.

> Sections 39(9) and 39(10): The Bank of England may require any information of any director, controller or manager of an authorized institution that it needs to determine if he/she is fit to serve in the position. The Bank of England has the same authority to require similar documentation of a "significant shareholder."

The IBAA opposes this unrestricted authority for banking regulators. It would give the regulator the right to become intimately involved in the daily management of the financial institution and to bypass the authority of the financial institution's management and board of directors. It is more appropriate that confidential information be transmitted to the regulator by the bank rather than by an accountant or auditor.

Certain statutes in U.S. law, including the Change in Bank Control Act, empower regulators to gather information on, and approve or disapprove, individuals who acquire banks. Section 914 of the FIRREA empowers regulators to gather information on, and approve or disapprove, individuals who are nominated to be directors or senior executive officers of new or troubled institutions. By authorizing regulators to obtain this information from bank officials at critical junctures in the life of an institution, these statutes suffice to preserve institutions' safety and soundness. The broad authority Sections 39(9) and 39(10) would grant regulators is unnecessary.

> Section 41: Investigations on Behalf of the Bank. The Bank of England may appoint an investigator (any competent person) to look into the activities of any authorized institution. They must notify the affected financial institution in writing after appointing the investigator. The appointee may investigate just as broadly as they are authorized to require information and documentation. The Bank may appoint any competent person to investigate any holding company, subsidiary, or other affiliate of the bank, following up with written notice to the institution. The investigator must give notice of request for information unless there is reasonable cause to believe documents may be destroyed.

This fulfills essentially the same function as the examination process in the United States. **We adamantly**

support the separation of banking powers as it currently exists and do not believe the U.S. examination process requires any substantive changes. Instead, community bankers urge the banking regulators to increase the experience level of certified examiners to improve the quality of on-site examinations. Currently, examiners are certified and sent out into the field after only a brief training period--as little as two years. Field examiners only rarely have hands-on bank experience. **The IBAA proposes that the banking regulators incorporate into the examiner training process bank internships, whereby examiner-trainees would gain practical experience in a financial institution similar to those they will be assigned to examine.**

Regulators should improve the examination process with better training and education of field examiners in the practical techniques and principles of community banking. Today, bank examiners generally do not have a good understanding of the communities served by the banks they are examining. We urge the bank regulators to enhance their examiner education programs with information about the communities and industries in the examiners' assigned territories. Community bankers believe that examiners need to be trained to be more sensitive and responsive to local economic conditions.

> Section 45: Audited Accounts to be Open to Inspection. The financial institution must make its audited financial statements available to the public on request.

This stipulation of British law is similar to existing U.S. regulation. U.S. financial institutions are required to give public notice that their financial statements are available for inspection by March 31 of the following year. **Because external audits are not generally cost-effective for small financial institutions, the IBAA opposes requiring externally audited financial statements. We believe current FDIC regulations that require a duly authorized officer of the bank to sign the financial statement attesting to its correctness if it is not accompanied by a certificate or report of an independent auditor are sufficient.**

> Section 46: Notification in Respect of Auditors. If an English financial institution removes or changes audit firms, it must notify the Bank of England. In turn, the auditor must give notice to the Bank of England if he chooses to leave the financial institution or does not seek

reappointment. If notice is not given, the auditor can be fined.

The IBAA believes the notification process is appropriate only for monitoring purposes to detect abuse. The banking regulators should not be involved in the financial institution's selection of auditors or other service-providers.

Section 47: Communication by Auditor, etc., with the Bank. Under Section 47(1), the auditor may communicate directly to the Bank of England any information the auditor discovers in his normal review of the financial institution, if the information is related to the Bank of England's supervisory duties under the 1987 law. Such exposure will not expose the auditor to any liability for breach of any legal duty.

The IBAA believes such an extremely broad placement of responsibility on the auditor would inappropriately contribute to the power of audit firms. Appropriate procedures would require auditors to follow due process procedures by communicating first with the institution's board.

IBAA opposes any statute which would limit or abridge the liability of auditors to any bank for breach of fiduciary duty, disclosure of privileged information, negligence, or other causes of action. No legal rights of any bank should be terminated by statutory or regulatory action.

Section 47(5): If the Treasury believes that any accountants or certain class of accountants are not subject to satisfactory rules or guidance, it may make regulations applying to those accountants.

The U.S. accounting industry has a well-developed process of regulation and most states have strict licensing requirements. **Banking regulator involvement in the licensing or certification process for auditors would be redundant and inappropriate. Rather than becoming involved in the regulation of another industry, banking regulators should work with the accounting industry, through proper channels, to repair any deficiencies in auditing standards for financial institutions.**

Section 82: Restricted Information. English law states that information cannot be publicly disclosed without consent of the subject and of the person supplying the information. And,

> Section 83: Disclosure for Facilitating Discharge of the Functions of the Bank. The Bank of England may disclose any information to the financial institution's auditor or accountant of record. The regulator may also disclose information as it deems necessary to obtain qualified advice.

The IBAA endorses restricting disclosure of information and opposes any direct communication from the bank's regulator to the bank's privately employed auditor. As stipulated in FIRREA section 931 and in the FDIC's policy statement, banking regulators should obtain information about bank audits directly from the bank. 58/ Auditors should be included in discussions and receive regulator communications only at the direction of the bank's board of directors. To assure effective supervision, the confidential nature of communications between bank and regulator must be strictly maintained.

> Section 85: Other Permitted Disclosures.

The IBAA agrees that banking regulators must have the authority to disclose any information necessary for criminal and other legal proceedings, and in disciplinary actions; however, these disclosures must be done with extreme discretion to protect the bank's right to due process, and to assure that community and depositor confidence is not unjustly eroded.

> Section 94: False and Misleading Information. Any person who knowingly or recklessly provides false or misleading information relative to the functions of the Bank or for obtaining authorization to accept deposits, or in any investigation is guilty of an offense and is liable: a) on conviction or indictment, to imprisonment for 2 years and/or a fine; b) on summary conviction, to imprisonment for up to 6 months and/or fine to statutory maximum.

The Financial Institutions Reform, Recovery and Enforcement Act has given federal regulators substantial new enforcement tools, particularly the power to impose massive fines on depository institutions and their managers. The early assessment of fines and penalties will only breed an adversarial relationship between financial institutions and their regulators. **The IBAA believes that financial institutions must be afforded sufficient time to learn the correct procedures and to change internal systems to accommodate regulation so that compliance is a mutual goal., It is critical that financial institutions be assured of their rights of due process**

by being given adequate time to respond to charges and make appropriate adjustments before exorbitant fines and penalties are assessed. We urge the regulators to adopt procedures which recognize and incorporate these rights.

2. Market Value Accounting

Comments have been requested on the feasibility of implementing market value accounting.

We recognize and accept current regulations which require market value accounting for securities held in a bank's trading account and other specifically identified transactions. However, the IBAA is adamantly opposed to market value accounting for all assets and liabilities of financial institutions. Community bankers do not believe that market valuation can be applied accurately or appropriately to traditional financial instruments. Mark-to-market accounting gives a point-in-time, shut-down picture of the firm. It does not measure the value of the institution as a viable, going concern.

Market value is based on estimates and projections. Values fluctuate significantly based on the individual analysis of various contingencies that could possibly occur, e.g., future interest rates, general economic and sector conditions, prepayments, etc. Estimates and projections, no matter how well developed or quantitative, are subjective. There is no "normal" market that can be assumed from community to community, region to region, or state to state. No active market exists for a large portion of the typical community bank loan portfolio or deposit holdings. Even with increasing markets for the assets of financial institutions due to the growth of asset securitization, prices are negotiated when the specific asset (or liability) is traded. Estimates of market value are subjective likely to be inconsistent and would not prove to be of any real value to the shareholders, depositors, and other users of a community bank's financial statements.

Mark-to-market accounting implies a short-term viewpoint and assumes frequent, rapid fluctuations in value. Community bankers are in the business for the long run; their business activities involve long-term relationships with their customers and communities. They do not make their profits from buying and selling assets. Community bank profits are earned based on interest rate spreads, the collectibility of loans, and efficient operations.

The technical costs inherent in mark-to-market accounting are exorbitant and beyond the capacities of the majority of community banks. Community banks frequently are managed by hands-on owners. Generally small in asset size, they have few employees and often do not have a CPA on staff. Market valuation would be a gold mine for accounting software firms and other service providers who will cash in on the local community's lack of seasoned and sophisticated accounting professionals.

Balance sheet accounts could fluctuate radically and place unrealistic demands on capital accounts. Market value accounting would drain liquidity from the system, especially if accounts were reported at the lower-of-cost-or-market (LOCOM). Because of cost and resulting balance sheet fluctuations, market value accounting would serve as a disincentive to issuing community-based loans and local municipal bonds.

Market value accounting would be particularly devastating to local communities and small businesses. Loans to small, local businesses are difficult to value. Financial institutions are likely to respond to mark-to-market accounting rules by making only loans that qualify for sale in the secondary market. This would change markedly the way most community banks do business. It could significantly hamper the community bank's ability to serve its local community. It would shut out many small businessmen and women from loans normally provided by community bankers who know and invest in their community. It would likely put more demand on government guarantees for small business, local home mortgages and other risky loans. Currently, community banks frequently offer and hold fixed-rate mortgages, which are still most popular with home-buyers. With the event of market valuation, community banks would be restricted to making only those fixed-rate loans that could be sold. Bankers would be forced to alter rates more frequently on loans they intend to hold to maturity to maintain the value of their portfolio. Similar action would be taken regarding rates paid on deposits -- fixed-rate certificates of deposit would no longer be a viable financing tool for financial institutions.

Mark-to-market accounting would significantly affect how community banks manage their assets and liabilities. The IBAA is concerned that market value accounting may induce portfolio management based on accounting rules, rather than to ensure the safety and soundness of banking activities. Accounting rules should be the means to the end of reporting the institution's financial condition. Market value accounting may become an end by forcing bankers to seek investment alternatives based on accounting treatment, rather than based on liquidity, cash flow and other economic needs.

Market value accounting is often promoted in the interest of providing needed information to the users of financial statements. However, investors do not base their investment decisions solely, or even primarily, on asset and liability values of an institution. Rather, they look at earnings and the expected return on their investment. To present a fair picture of the institution, mark-to-market valuations would have to include estimates of the present value of future cash flows generated by the assets and paid for the liabilities, a monstrous task at best. We believe market valuation has limited use for the investor and is extremely costly to generate.

Comments have also been requested on the feasibility of exempting long-term assets from market value accounting. Long-term is generally defined as anything greater than one year.

Long-term assets should not be subject to market valuation. The American Institute of Certified Public Accountants (AICPA) recently issued a Statement of Position (SOP) that applies LOCOM accounting to any security that will probably be sold in the "foreseeable future." Foreseeable future is defined as anything less than one year and any known events expected to occur beyond one year. "Probable" is a subjective estimate of the likelihood of an event occurring.

IBAA supports the definition of foreseeable future as one year. However, we believe that a safe harbor allowance for unanticipated sales must be included as part of the accounting statement. The analysis required by bankers to anticipate future events, which would cause them to sell their investments and then to determine the probability of these events occurring, is excessively burdensome for community banks. A safe harbor provision allowing for a miscalculation of sales up to 10 percent of the financial institution's portfolio is appropriate and necessary to make this accounting standard feasible. The IBAA urges banking regulators to provide the 10 percent safe harbor if this accounting rule is implemented.

3. Risk Management Techniques

Comments are requested on regulator examination of risk management techniques.

Risk management is not a new concept; more than 150 years ago the Board of Trade of the City of Chicago was formed by local grain merchants. An underlying desire of these merchants was to transfer risk associated with unexpected commodity price changes. The Board served to expedite commodity sales and investment in storage facilities -- some merchants and speculators were willing to bear the cost of storing grains in expectation of future price increases. 59/ In recent years, this concept has been applied to financial futures as well; many "new" financial instruments and techniques have emerged to help financial managers control risks.

In 1975, the Chicago Board of Trade introduced the trading of Government National Mortgage Association (GNMA) contracts to hedge mortgage-related debt. In the same year, the Chicago Mercantile Exchange launched trading of Treasury bill contracts to hedge short-term money market risks. In 1977, the Board of Trade began trading Treasury bond contracts. These instruments opened new opportunities for hedging cash bond positions and transferring risk. By the early 1980s financial instrument contracts were widely traded, with the Treasury bill contract becoming the second most actively traded commodity contract in 1983. 60/

For banks and other financial institutions, financial futures are a means to manage their assets and liabilities, to match interest-sensitive assets to interest-sensitive liabilities and to maintain a positive spread between the two ("gap management"). Banks can hedge their portfolios with futures contracts, swaps and options. However, since these instruments are marked-to-market in the bank's trading account, their book value changes while actual cash market gains and losses are deferred until realized. This may result in greater volatility in reported earnings. Too often, banks are forced by their boards, shareholders or regulators to be concerned with short-term accounting earnings rather than true, long-term economic value. In these cases, hedging and futures strategies are not viable tools. 61/

Many banks manage risk by diversifying their portfolios through the use of asset securitization, loan sales, exchanges and participations. Asset securitization allows the bank to reduce assets on their balance sheets while at the same time maintaining a relationship with the borrower. Individual credits are pooled and a separate legal entity is created to own the assets and "purchase credit enhancements from third parties." 62/ Loan sales, depending on the terms of the contract, can transfer the entire credit, including risk, to a new owner. Generally, sales agreements include servicing contracts whereby the originating bank maintains its relationship with the borrower. Loan exchanges and participations are variations of loans sales and serve as diversification tools for both parties to the transaction.

The IBAA believes regulatory supervision of all aspects of bank operations, including risk management, is vital to ensure the safety and soundness of the banking system. At the 25th annual Conference on Bank Structure and Competition sponsored by the Federal Reserve Bank of Chicago, Federal Reserve Board Governor John LaWare said that, instead of regulation, "we need intelligent supervision doing an in-depth job of monitoring what is going on in all these institutions and the authority to move quickly and peremptorily when something goes wrong." Governor Manuel Johnson complemented LaWare's remarks: "To prevent problem banks from becoming threats to the safety net and the financial system, it is necessary to give examiners stronger tools." 63/

In practice, however, community banks often feel field examiners discouraged their use of risk management techniques. Community banks frequently are criticized by examiners for over-concentration in their geographic areas (a risk inherent in community banking). At the same time, banks are cited for "out-of-area" lending when they hold loan participations or have bought loans outside their market area. Examiners sometimes concentrate more on reported accounting earnings for the period rather than true economic cash flows. Therefore, banks are criticized unduly for the increased volatility in accounting earnings inherent to risk management techniques. The emphasis placed on short-term earnings should be balanced with the long-term effects of risk management techniques.

Community bankers concede that they need more education, guidance and experience in the use of "new" financial instruments as risk management tools. More disclosure in financial statements is needed about complex and generally less familiar financial instruments. **The IBAA encourages the banking regulators to develop guidelines for these tools, educate both bankers and examiners in the proper**

application of these tools, and encourage the use of non-traditional risk management techniques such as swaps, hedging, futures and asset securitization. The IBAA also urges the federal regulators to work with state regulators to develop mutually acceptable supervision of these activities.

We urge the banking regulators to facilitate a change in the attitudes of their regional examiners toward risk management techniques. An attitude of acceptance and support is needed to encourage community bankers to become more active in progressive risk management techniques. Education programs directed to both bankers and examiners should be improved. Such education programs should 1) assist examiners in being more sensitive and responsive to local economic conditions and the need for risk management, and 2) inform bankers of the proper role risk management instruments can play in their portfolios.

The private sector Accredited Standards Committee X9 on Financial Services has proposed forming a subcommittee to consider basic standards for loan documentation. Standardization of loan documents will pave the way for increased asset securitization and easier loan sales. **The IBAA recommends that federal and state banking regulators take an active role in the development of loan documentation standards by the private sector, and incorporate these standards into official guidelines for financial institutions.**

C. INCENTIVES TO CONTROL RISK

1. Scope of Deposit Insurance Coverage

Comments are requested on the scope of deposit insurance coverage and its impact on the liability of the insurance fund; that is, whether to change the level of deposit insurance and/or the types of deposits and accounts eligible for coverage. The incentive for market discipline by providing de facto insurance for all accounts in certain circumstances may also be discussed.

Specific comments are requested on: 1) limiting each depositor to one insured account per institution; 2) reducing the amount insured, or providing for a graduated decrease in the insured percentage of amount deposited as the amount deposited increases; 3) combining federal with private insurance to bring market discipline; and, 4) ensuring by law or regulation that when an insured institution is closed, that only the explicit liabilities will be honored.

We will first address the scenarios put forward to reduce deposit insurance coverage (numbers 1 and 2). **IBAA strongly opposes these proposals and believes that, if adopted, they could cause significant negative effects on the deposit flows of small financial institutions. In addition, we believe that these reforms would seriously undermine consumer confidence in our financial system. We share Chairman Seidman's viewpoint that a system is not in place in the United States which would permit the failure of the nation's largest institutions. Therefore, none of their depositors are at risk. Additionally, only such larger institutions present a systemic risk to the deposit insurance system. The IBAA urges that the nation's smaller institutions be accorded full coverage equal to that given the larger institutions.**

Since the proposals to limit or reduce coverage directly affect consumers, IBAA decided that the consumers needed to be asked how these proposed changes would affect their savings habits. Therefore, in August 1989 IBAA retained Market Facts, Inc., a major marketing research organization, to conduct a telephone survey of consumers who have accounts with insured depository institutions to determine their views on deposit insurance (see Appendix D). The survey was conducted among a nationally representative sample of adults 18 and older who have either a savings, checking, money market account, IRA, or CD with a bank, savings and loan, or credit union. In order to provide a large enough sample of respondents with large deposits ($50,000+), the national probability interviews were supplemented with a sample of higher income respondents (household income of $50,000+). The general population data which served as the basis for the report was weighted to reflect national estimates with regard to gender, age, income, and region.

More than eight in ten adults said that they had either a checking, savings, or money market account, IRA, or CD with a bank, thrift, or credit union. Savings were low, with 48 percent of the population reporting less than $10,000 total in checking, savings, money markets, CDs, and IRAs.

In an effort to ascertain perceptions about the safety of money in various sizes and types of institutions, respondents were asked whether they felt their savings were safer in a large statewide or nationwide bank, or in a small local or community-owned institution. The majority believed that their savings were equally safe in a large or small bank (67 percent). However, the size of a financial institution clearly influenced some people's perceptions, as nearly one-quarter thought their money was safer in a large bank, while only 9 percent prefer a small bank. (See Tables 1 and 2). IBAA believes that this can be directly attributed to the too-big-to-fail policy.

More than four in ten (45 percent) said that the type of deposit insurance coverage affects their decision as to the type of institution they use for savings. There was a significant regional difference in this category. Fifty-three percent of Southerners considered the type of deposit insurance when making their savings decisions (which could be indicative of the higher failure rate in the South) as compared to 34 percent in the Northeast. Individuals with savings of $50,000 and above were more sensitive to the type of federal insurance than were those individuals with lower savings. Fifty-eight percent of those with savings of $50,000 or more claimed they considered the type of federal deposit insurance when choosing where to save.

Respondents were informed that their deposits were fully insured up to a ceiling of $100,000 at each depository institution. Respondents were asked whether a reduction in this ceiling, a 10 percent deductible, or co-insurance would affect how much or where they saved. One-half (50 percent) of the general population said they would change their savings habits if the

$100,000 deposit insurance level were reduced to $50,000 (see Table 3).

A ceiling reduction had an even more dramatic effect on the savings behavior of those with large deposits. Nearly four in ten persons (39 percent) with savings greater than $50,000 claimed that they would change their savings behavior if the insurance limit were dropped to $90,000 and 75 percent said that they would change their savings habits if insurance were dropped to $50,000.

Distributing savings across institutions would be the most prevalent change in behavior (see Table 4). Fifty-eight percent of those that would alter their savings habits said that a limit in coverage would cause them to distribute their savings across more institutions, while 18 percent said that reduction would cause them to maintain less money in a savings account. IBAA notes that distributing funds across institutions does not reduce the overall contingent liability of the insurance fund.

Two-thirds (67 percent) of the general population maintained that if federal insurance only covered 100 percent of losses up to $10,000 in deposits if the institution failed, and customers were required to cover 10 percent of any losses between $10,000 and $100,000 they would change how much or where they saved. Large depositors were even more likely (83 percent) to change their savings behavior.

The IBAA concludes from this study that attempts to change deposit insurance will prompt the consumer to change his/her savings behavior without any accompanying decrease in liability to the insurance fund. The fact that the majority of depositors had low savings (less than $10,000) did not change their conclusion that they would have to change how they saved if deposit insurance were lowered. We conclude that this is the result of the perception of risk that a consumer has when he/she deposits money in an insured institution. Furthermore, reducing deposit insurance could lower the savings rate, which would be a very poor public policy choice. It is IBAA's determination that deposit insurance risk cannot be shifted to the depositor without causing severe problems with the public's perception of the safety of our financial system.

In addition, the IBAA believes that limiting each depositor to one insured account per institution would create costly administrative and operational burdens for small financial institutions and account owners.

Accounts are routinely established using a variety of ownership types or arrangements. It is not uncommon for individual accounts to have up to four owners, e.g., parents and two children. Under current rules, each separate set of beneficial owners are entitled to full coverage. An individual can be included as a beneficial owner in any number of accounts, for example, as a joint account holder or as a custodian.

A rule limiting an individual to one insured account could throw these situations into confusion. If two children have separate accounts, their parents have a separate account, the parents and children share a joint account, and all accounts have balances below $100,000, who are the insured depositors? An account established under the Uniform Gift For Minors Act would also present a special problem in determining the insured depositor. Generally, this account is opened in the guardian's name for benefit of the minor, using the minor's social security number. When the account is opened, is the guardian the insured depositor? Who is the insured depositor when the minor reaches legal age? These are just two isolated examples of application complexities.

Tracking the insured depositor at each financial institution would be a massive record keeping challenge for banks. A tracking system utilizing the uniqueness of the social security number is probably the most likely. In order for banks to implement such a proposal, each account owner would require a separate customer file established by customer name and social security number. Very few financial institutions currently have computer systems with this capability. Most computer systems have the capability to establish only one or two customer files per account regardless of the number of account owners. Many financial institutions, including large money center institutions, operate separate computer systems for different product lines. It would be difficult to integrate the various computer systems. Smaller banks unable to justify costly computer enhancements might be forced to implement some type of laborious and error-prone manual tracking system.

The administrative and operational burdens imposed by limiting each depositor to one insured account per institution are almost identical to the burdens of implementing backup withholding. To date, community bankers have found backup withholding temporary regulations to be extremely difficult, confusing and costly to implement. Bank customers have also found backup withholding disclosures and notices very confusing. This customer confusion has often resulted in strained bank-customer relations. In order to comply with the regulations, banks have been forced to install expensive software and hardware enhancements that do not provide commensurate benefit to their overall operation and profitability. Other banks have resorted to time-consuming manual tracking systems in order to comply with backup withholding regulations. The Internal Revenue Service has delayed further implementation of its backup withholding program.

The IBAA urges the Treasury to be mindful of the problems experienced in the implementation of backup withholding when considering limiting deposits to one insured account per institution.

Scenario 3 suggested combining federal and private insurance to bring market discipline to bear on the management of depository institutions. For this to be a viable alternative, private insurance must be available to all institutions at a reasonable price. In the Fall of 1989, the IBAA retained the management consultant firm of Edgar, Dunn & Conover to assess the availability and cost of private deposit insurance coverage. (See Appendix E).

The conclusion of that study was that private deposit insurance is not an option for replacing the existing federal deposit insurance system. Two patterns emerged from the study: insurance companies that were not active in the financial guaranty business were not interested in becoming involved; and, the financial guaranty sector of the industry, while exploring the possible market, was highly skeptical.

The study found that the financial guaranty sector of the insurance industry is in the process of exploring whether there is a set of conditions which if met would create an opportunity for some form of private insurance. The insurance industry's assessment is scheduled to be completed in 12-18 months, but they remain highly skeptical of developing a viable product.

Furthermore, the insurers studying the potential market indicated that availability of private deposit insurance will be highly selective. Most small financial institutions would be excluded as potential customers due to their size and the high cost that the insurance industry believes would be incurred to assess an individual institution's risk. Coverage, even if ultimately offered, would not be universally available.

The Market Facts, Inc., study on deposit insurance commissioned by the IBAA in August 1989 also found that private insurance would not be widely accepted by the public. Forty-five percent of those surveyed said that they would change their savings habits if deposit insurance were reduced to $50,000 and a private company insured amounts over $50,000. Large depositors would be more likely (59 percent) to change. The most frequent reaction of depositors to the introduction of co-insurance was that they would distribute their savings among institutions. Thus, not only would small institutions lose many deposits due to savers shifting their saving patterns, but they would also find it difficult to locate private insurers willing to take on the risk of covering the small institutions.

The IBAA concludes that private insurance cannot be considered a viable alternative for federal deposit insurance. This type of coverage is, at best, academically interesting, but not practical in the real world. No joint public-private deposit insurance program can operate effectively without a clear delineation of which guarantors are responsible for specific portions of the total risk. IBAA does not believe that the FDIC has appropriately delineated the risk inherent in the deposit insurance system and doubts that private insurers would be able to successfully undertake that task.

The fourth option presented was to ensure, by law or regulation, that when an insured depository institution is closed, the appropriate federal insurance fund will honor only its explicit liabilities and will never honor any losses on deposits not explicitly covered by federal deposit insurance. This is a very narrowly written option, since it would apply only when an insured institution is closed. Under the too-big-to-fail policy, no major institution would be "closed" if this option became the law. It would provide only a semantic adjustment to current policies.

Today, depositors in deposit payoff and insured-deposit transfer transactions generally receive immediate reimbursement only for their insured deposits. These depositors may receive additional reimbursement once the value of liabilities to assets is determined. In purchase and assumption and whole-bank transactions, all deposits are fully protected. Under the suggested option, the government could simply refrain from using a deposit payoff or insured-deposit transfer settlement method if the institution was deemed too-big-to-fail.

2. Risk-Based Premiums

Comments are also requested on the feasibility of charging risk-based premiums for federal deposit insurance. A number of criteria, including asset quality, interest rate risk, management quality, profitability, and capital are all suggested as elements in determining risk.

The IBAA has considered risk-based premiums and their possible impact on community banks. All the factors listed above do have an impact on risk. However, we do not have access to the detailed statistical data concerning the condition of the banking industry that we believe is necessary to determine how these factors should be measured and weighted, and how much premiums should differ.

We believe that asset quality and interest rate risk would be more appropriately included in the assessment of capital adequacy. IBAA supported the adoption of the risk-based capital framework which the bank regulators developed over the past several years. We recommend that the agencies work together to determine if a risk-based premium program is feasible and if it would be compatible with the existing regulatory environment -- including the new risk-based capital standards.

IBAA would also note an answer given in 1985 by then-Federal Reserve Chairman Paul Volcker on the advantages and the disadvantages of risk-based capital and risk-based premiums, with which we strongly agree:

> Risk-based capital standards and risk-based deposit insurance have important similarities and also significant differences. Regarding similarities, an objective of both approaches is to establish greater market-type inducements for reducing risk-taking by depository institutions. Other common objectives are to create a more equitable distribution between low- and high-risk banks of the public and private costs of risk-taking and to protect depositors and other creditors of a failing bank from loss. Both also share similar practical difficulties in accurately measuring bank risk-taking exposure on an ex-ante basis.
>
> One difference between these two arrangements is that, if, say, the risk exposure of banks generally were to rise, the capital position

> of individual banks would be built up under risk-based capital while the deposit insurance fund of the banking system would grow under risk-based insurance. The consequence of that difference is that individual banks would be better positioned to absorb the losses resulting from their higher risk exposure -- and thus less prone to fail -- in the case of risk-based capital while the deposit insurance fund would be better placed to deal with failures that nonetheless occur in the case of risk-based insurance.
>
> Another difference is that risk-based capital appears to afford the supervisor more flexibility and discretion than a risk-based premium system. A risk-based insurance system would seem to require the insuring agency to publish a fixed schedule of fees to be charged against different levels of risk and to specify in some detail the variables to be referred to in determining these fees. Moreover, there would seem to be little room to depart from relying solely on that approach in gauging the risk exposure of individual institutions or to make adjustments in either the amount, or the timing in the payment, of risk-based premiums....64/

Like Chairman Volcker, IBAA sees problems with a risk-based premium system. We believe that it is premature to consider this as an alternative to the current system without much more detailed information on how a risk-based premium framework would be established, priced and monitored. In addition, we believe that the information must include a detailed analysis on the effect risk-based premiums would have on the insurance fund.

3. Capital Adequacy

Commenters are asked to consider capital adequacy as a means of protecting against a depository institution's level of risk to the insurance fund. The IBAA has commented on all recent capital proposals of the banking agencies. **We strongly believe that adequate capital is the cornerstone to the safety and soundness of our financial system and to the insurance fund. One of the primary reasons that the thrift**

industry has had such significant problems is lack of adequate capital. IBAA believes that it is the responsibility of the banking agencies to ensure that the banking industry maintains the appropriate level of capital.

IBAA endorsed the risk-based capital framework when it was proposed several years ago. However, our support of this new framework for measuring capital adequacy was tempered by our concerns that the agencies grant an adequate phase-in for the program to allow time to learn how the system would truly affect the banking industry and also its impact on the regulatory process. We also commented that we believed the existing capital ratios should be used in tandem with the risk-adjusted capital ratio at least until the end of 1990. IBAA also does not believe that the agencies are adequately prepared to make complete and accurate assessments of capital adequacy solely on a risk-based framework.

As the agencies implement the risk-based capital ratios adopted in 1989, we urge them to make a continued educated assessment of the effectiveness of these ratios. Because of the lack of regulatory experience with risk-based capital, we support the concept of a minimum leverage ratio.

The OCC and the Federal Reserve Board (FRB) have proposed to retain a minimum leverage ratio in addition to the risk-based capital requirement. Specifically, as of December 31, 1990, national bank and state-member banks would have to satisfy both a 3 percent Tier 1 capital-to-total assets and the minimum risk-based capital standard.

The IBAA has expressed its concern to the banking agencies that a 3 percent Tier 1 minimum leverage test is too low. While loan loss reserves are not considered Tier 1 capital, 3 percent pure equity still seems to be an inadequate cushion for safety and soundness. A bank could readily lower its capital provided it developed a low-risk balance sheet profile. However, once a bank lowers its capital there is nothing to prevent that bank from changing the composition of its balance sheet to one of high risk almost overnight. By the time the regulators recognized a switch like this, it could be too late to require higher capital. Unfortunately, the thrift industry again is a perfect example of what can happen to a federally-insured depository system that switches to high-risk activities without adequate capital.

IBAA believes that an insured financial system requires a higher minimum leverage ratio than that presently being considered by the OCC and FRB. A more adequate minimum leverage ratio would be more than 4 percent Tier 1 capital. The first level of protection of the insurance fund is the bank's capital. When equity is reduced, the risk to the insurance fund increases. Since capital adequacy is assessed on an ex-ante basis, the insurance fund cannot afford to let a bank whose risk is low today reduce its capital to match that risk without opening the fund to much greater risk tomorrow.

4. Optimal Fund Reserve Level

Comments are requested on the relationship of the current system's assessment structure to the optimal level of insurance fund reserves.

a. Broadening the Base

Our comments in other sections recognize that all the liabilities of major banks, including non-deposit liabilities and foreign deposits, are now contingent liabilities of the Bank Insurance Fund. We also recommend that all banks be granted the same insurance coverage enjoyed by the too-big-to-fail banks. This requires that all of the industry's liabilities be assessed. In addition, it requires that the BIF's optimal reserve level be measured against this larger base.

In the past the adequacy of the insurance fund has been measured against the amount of insured deposits in the banking system, excluding domestic deposits over $100,000, non-deposit liabilities, and all foreign deposits. However, because the bulk of these technically uninsured liabilities are in too-big-to-fail banks, they are *de facto* contingent BIF liabilities, even under current law and practice. Therefore, we recommend the statutory change necessary to include nondeposit liabilities and foreign deposits in the base against which the insurance fund is measured.

The following table sets forth key features of the current system and our base-broadening recommendation:

Current System

Base:	Insured deposits
Required reserve level:	1.25%
Year level is reached:	1993
Amount in fund in 1993: (see Table 5)	$29 billion

Base-Broadening Recommendation

Base:	All domestic deposits, all foreign deposits, non-deposit liabilities
Required reserve level:	1.25%
Year level is reached:	1996
Amount in fund in 1996:	$56 billion (equals 1.4% of base) (see Table 6)

The base-broadening that we recommend would delay reaching the new recommended target reserve level by three years, under current projections. However, it would recognize the BIF's broader responsibilities, permit full coverage for all institutions, and provide the taxpayers with a substantial assurance that they will not be called upon to pay for losses incurred by commercial banks.

However, it is critical that this larger fund not be used to pay for losses in the savings and loan industry. This would be unfair, and it would be unwise to tap these funds which may be needed to preserve the future stability of the nation's financial system.

We also recommend that the BIF not be included in the federal budget. As long as it is included in the budget there is a greater temptation to use BIF income to offset other spending. But the fund has critical functions which are not subject to traditional budget discipline. When the FDIC must spend money from this fund its action is in no way discretionary -- the money must be spent or else problems could well get worse. Furthermore, the fund is completely funded by the commercial banks -- taxpayers have never been called on to pay for bank losses. As long as this remains the case the Bank Insurance Fund does not belong in the federal budget.

b. The Optimal Level

Having recommended a broadened base, this section discusses what percentage of reserves the FDIC should hold in BIF against that base.

Under FIRREA, the Bank Insurance Fund's reserves are projected to increase steadily to their target level of 1.25 percent of insured deposits. This is because FIRREA dramatically increased insurance assessments that banks must pay from $.083 per $100 of domestic deposits to $.12 in 1990 and $.15 thereafter. This additional money will restore the BIF to its historical coverage ratio of approximately 1.2 percent within a few years according to current projections (see Table 5).

The question raised in the request for comments concerns the relationship between these higher assessment levels and the "optimal level of insurance fund reserves."

It is difficult to determine precisely an "optimal level" for the BIF, whether measured against insured deposits or a broader base. It can be best described in terms of results: if the fund is stable and adequate in comparison to its potential liabilities, it is large enough. A shrinking fund is a cause for concern. It is likely that the optimal reserve level will not be a static figure and should only be quantified in light of the health of the banking industry and the general economy.

Recognizing the difficulty of being precise, FIRREA gives the FDIC ample authority to adjust assessments and the level of the BIF to changing circumstances. These are the steps that the FDIC can take:

1. Permit the fund to increase above the reserve level of 1.25 percent to the ceiling of 1.5 percent;

2. Increase assessments by $.075 per $100 of domestic deposits in any year that the fund falls below 1.25 percent of insured deposits or any higher level (up to 1.5 percent) if the FDIC finds that there is a significant risk of substantial future losses;

3. Increase assessments to a total of $.325 per $100 of deposits -- more than double the 1991

rate -- to cover anticipated losses.

Under this new system the FDIC could, in the direst circumstances, maintain the BIF at its highest permissible level and impose higher premiums to cover its current costs. However, it can choose among its options in less serious circumstances.

Given this range of options, we question the necessity of permitting the BIF to grow to 1.5 percent of its potential liabilities. The purpose of the overall cap is to prevent the fund from becoming so large that it diverts capital out of banks to the detriment of the financial system. A fund that is too large would put capital into government hands that could be more efficiently mobilized by the private sector.

Under prior law, the fund was required to be within a range of 1.1 percent to 1.4 percent and was generally maintained at around 1.2 percent -- somewhat below the new 1.25 percent target. This was adequate for the first 50 years of the FDIC. Even during the recession of the early 1980s, which produced record numbers of bank failures, the fund (now BIF) still has more than $14 billion in reserve.

However, circumstances have changed; the potential liabilities of the BIF have broadened. In our earlier comments, we have recommended that the fund be permitted to grow far above 1.25 percent of insured deposits. But, we believe that the target reserve level of 1.25 percent of all potential liabilities would provide for an adequate fund with its broader responsibilities.

Therefore, IBAA recommends that the FDIC use its authority to move above the new 1.25 percent target level only under the most threatening circumstances. In relatively stable times, a fund of 1.25 percent of all domestic deposits, non-deposit liabilities and foreign deposits, would be an ample reserve. And, we note that the reserve level could be maintained in times of stress by assessing higher premiums for short periods of time rather than building a larger fund.

While we recognize that a deposit insurance fund that is too small imposes unacceptable risks to the taxpayers, the new system of assessments introduced in FIRREA is flexible enough to provide the FDIC with ample flexibility to maintain the integrity of the fund without the need for a long-term reserve level above 1.25 percent.

Part III. CLOSURE OR RECAPITALIZATION OF INSOLVENT, OR NEARLY INSOLVENT, INSTITUTIONS

A. CLOSURE OR RECAPITALIZATION POLICIES

Comments are requested on policies to be followed when determining whether to recapitalize or to close federally insured depository institutions that are, or are about to become, insolvent.

Regulators should adopt definite standards for determining when a weakening institution has reached such low equity capital levels that it should be closed. For example, when the OCC in November 1989 adopted a regulation stating when the OCC would consider a national bank to be insolvent (54 FR 48851), the IBAA supported the publication of such standards in a regulation.

However, we objected to the Comptroller's decision not to use risk-based capital standards in determining insolvency. These new standards best measure the capital available to a bank to absorb losses.

In particular, the OCC's "early intervention" capital standards exclude the allowance for loan and lease losses (ALLL) from capital when determining insolvency. Since a bank's ALLL is available to cover the potential losses that a bank will encounter, regulators should include the ALLL in the bank's capital base under the early intervention policy.

Since the early intervention policy is, obviously, crucial to the life of an institution, it is important that the capital standards be uniform and clear. Thus, while we generally recommend that the previous capital standards be used alongside the new risk-based standards, in this instance the regulators should use a uniform standard. Measuring an institution's capital is difficult enough without the confusion of varying capital standards. (See Appendix F on capital definitions.)

Standards for insolvency should be phased-in to provide marginal institutions time to build capital and comply without unduly jeopardizing the financial system. Finally, IBAA believes that capital adequacy assessment must incorporate consideration of tangible equity capital.

To summarize: Regulators should set an equity capital level at which a bank is deemed insolvent and is closed. This level should conform to risk-based capital standards, including counting the ALLL as Tier 2 capital.

B. ALTERNATIVE FEDERAL DEPOSIT INSURANCE SYSTEMS

Our comments under other sections address the issues raised in this section in more detail. **In summary, we do not believe that there are credible or feasible alternatives to federal deposit insurance. Private insurance is unavailable and is unlikely to become available for the vast majority of depository institutions, especially community financial institutions. The public does not believe that private insurance would provide them with sufficient protection.**

Although deposit insurance provided at the state level has a long history, such systems have demonstrated marked weaknesses. For example, problems have occurred most recently with private (but state-authorized) deposit insurance in Ohio and Maryland. The entire Ohio system was brought down very quickly by the failure of one institution which was large in relation to the size of the fund.

In another notable breakdown, the Maryland Savings Share Insurance Corporation, a non-profit corporation created by the Maryland legislature in the 1960s to provide deposit insurance for state-chartered thrifts, failed in the 1980s. Its failure was catastrophic; after years of waiting, some depositors in several failed Maryland chartered savings and loans have still not received their money.

These state-authorized insurance schemes failed when they were needed most -- in times of crisis.

Most depositors in federally insured savings and loans have remained calm in the face of a constant stream of news reports about the crisis in the industry. For over 50 years the federal deposit insurance system has provided for stability and public confidence unavailable under any other scheme.

Federal deposit insurance makes it possible for thousands of locally-based financial institutions to gather deposits and -- under appropriate loan underwriting procedures -- lend that money to local consumers and businesses. This credit is the lifeblood of thousands of local communities. Without federal insurance these deposits would flow into the nation's too-big-to-fail money center banks and would not be as available to fulfil local credit needs. We strongly recommend that federal deposit insurance remain in place and that state deposit insurance systems not be considered as replacements or supplements to the federal guarantee.

C. MODIFYING THE INSURANCE BASE

Comment is requested on whether the insurance base should be modified. Specifically, comments are requested on the feasibility and effect that each of the following would have on the insurance system: 1) adding collateralized borrowings to the insurance base; 2) limiting brokered deposits; and, 3) assessing premiums on foreign deposits. Commenters are also requested to address the desirability of retaining multiple insured accounts.

The inequities in the existing insurance assessment base were well summarized in President Bush's 1991 budget documents. The Administration document noted:

> Large banks pay lower effective premiums because insured deposits are a smaller share of their funds; they obtain a higher share from deposits over $100,000, foreign branches, and other borrowing. The effective extension of insurance coverage to deposits over $100,000 and uninsured creditors decreases the incentive of uninsured parties to monitor risk-taking, allowing depository institutions to take more risk and increasing the insurance funds' exposure to loss. 65/

1. Assessment of Foreign Deposits

Foreign deposits enjoy *de facto* deposit insurance coverage and it is patently unfair that these deposits are not assessed. IBAA believes that assessing foreign deposits is not only feasible; it would also bring significant income to the insurance fund.

A foreign deposit is a deposit held in a foreign branch of a domestic bank. Many of the money center banks have opened branch offices in foreign countries and actively engage in deposit-gathering activities. Deposits held in branches located in foreign countries are not assessed FDIC insurance premiums and are not subject to the Federal Reserve's reserve requirements. These deposits were also not subject to the interest rate restrictions of Regulation Q when it was in place.

Foreign deposits may be in any amount and may be owned by anyone, including Americans. It is not unusual for a large U.S. company to deposit funds in a foreign branch of its U.S. bank in order to earn a higher return on its deposits. The higher return is possible due to the foreign branch's lower cost of funds.

As of September 30, 1989, foreign deposits totalled $331 billion. Assessing these deposits at the current premium of 12 cents per $100 would result in annual revenue to the BIF of nearly $400 million. By 1991, banks' insurance premiums will increase by almost 80 percent to 15 cents per $100. If foreign deposits remained stagnant at $331 billion and were assessed at the increased premium rate, the yield to the BIF would be almost $500 million annually (see Table 7). The banks that hold the largest percentage of the foreign deposits have an obvious bottom-line interest to ensure that these deposits are not included in the assessment base (see Table 8).

Money center banks have claimed that the deposits gathered at foreign branches do not fund their consolidated operations. The facts do not support this statement.

As of December 31, 1988, 254 U.S. banks held deposits gathered from their foreign branches. There are approximately 743 foreign branch offices; the five largest U.S. banks account for 464 of those offices. Current FDIC reports show that the top 25 banks held approximately 85 percent of the foreign deposits, while the top five banks held 50 percent of the total foreign deposits. For each of the top five banks, foreign deposits contributed significantly to the banks' total deposits. For example, as of September 30, 1989, foreign deposits as a percentage of total deposits equaled 60 percent at Citibank, 81 percent at Morgan Guaranty, 54 percent at Chase Manhattan, 59 percent at Bankers Trust and 45 percent at Manufacturers Hanover (see Table 8). It is difficult to accept the proposition that deposits which contribute approximately 50 percent of a bank's total deposits are not being utilized to fund consolidated operations.

Foreign deposits provide larger banks with a less expensive funding source when compared to the costs of utilizing domestic deposits. To illustrate this savings, note that Citibank paid $46 million in FDIC premiums at the then current rate of 8.3 cents per $100. If Citibank's foreign deposits had been assessed, this would have translated into an additional $49 million annually.

A study prepared for the U.S. Banker by Olson Research Associates in April 1989 showed that the proposed higher FDIC premiums of 15 cents per $100 will reduce the net income of most banks by 3 or 4 percent. 66/ The reduction in earnings for the largest banks, however, will be significantly less than for the average bank. Because foreign deposits are not assessed, the study indicates that the reduction in income for the largest users of foreign deposits will be only approximately one percent.

Another argument commonly used against assessing foreign deposits is that U.S. banks will transfer deposits from the foreign branch into a foreign subsidiary of the bank. This argument overlooks the fact that the ability of U.S. banks to operate wholly-owned foreign subsidiaries is completely dependent upon the laws of the host country, not the laws of the United States. Many foreign governments require U.S. banks to operate through local branches. Several U.S. Circuit Court cases have recognized that U.S. banks may not be permitted to establish a wholly-owned bank subsidiary as a result of the host country's laws. 67/ If foreign deposits were assessed, U.S. banks would have to consider the requirements of the laws of the host countries where their branches are located prior to transferring any funds.

One of the most serious arguments that has been offered against the assessment of foreign deposits is that it would dilute the BIF by forcing it to cover these deposits. It is our view that the BIF is already diluted because foreign deposits enjoy de facto coverage and the situation will not be corrected unless those deposits are assessed.

As we indicated in our comments on the "optimal fund reserve level" we recommend that all potential liabilities of the BIF be assessed and that they be considered insured deposits in calculating the fund's coverage ratio. The coverage ratio is determined by applying the amount in the fund to the total of insured deposits.

We recognize that our recommendation to extend coverage to all potential liabilities will put off the day that banks receive rebates. However, we are willing to delay receiving rebates if it means that all potential BIF liabilities are assessed and the fund is truly large enough to meet its responsibilities. Our primary concern is for the safety and soundness of the insurance system and ultimately our financial system.

In conclusion, amending the Federal Deposit Insurance Act to extend deposit insurance coverage to foreign deposits will bring significant income to the

BIF and improve its ability to meet all of its responsibilities.

2. Assessment of Non-Deposit Liabilities

Comments are requested on whether collateralized borrowings should be added to the insurance base. **We recommend that these liabilities, as well as other non-deposit liabilities such as "deposit notes," be included.**

The IBAA has long advocated the assessment by the FDIC of non-deposit liabilities, since these instruments represent a liability to the insurance fund. The FDIC has stated that it believes it will be required to provide insurance coverage to all deposit notes in the event of bank failure, even though the bank may not have paid deposit insurance premiums on these notes. Senator Alan Cranston (D-CA) recently introduced S. 2010, the Bondholders Protection Act of 1990. This bill would permit 20,000 individuals, mostly elderly Californians, who purchased American Continential junk bonds through Lincoln, to sue the U.S. government to recover damages. In a speech before the Senate, Cranston said:

> Many of the individuals who purchased these bonds believed that they were purchasing federally insured bonds. I believe they were let down by the Federal agencies - particularly the FHLBB - who should have been protecting their interests. 68/

This bill is an example of the safety net being extended even beyond too big to fail in a manner inconsistent with the current assessment base.

Many financial institutions believe deposit notes are de facto FDIC insured. Obviously if the banks issuing the notes believe they are insured, they should have no problem paying the deposit insurance assessment. Some institutions even include statements on deposit insurance coverage in their deposit notes offering circulars. In an offering circular issued by the Citizens and Southern National Bank on July 1, 1988 they state,

> THE BANK BELIEVES THAT THE DEPOSIT NOTES CURRENTLY REPRESENT FDIC INSURED DEPOSITS; HOWEVER, THE ULTIMATE DETERMINATION OF THE INSURABILITY OF THE DEPOSIT NOTES WOULD BE MADE BY THE FDIC IN RESPONSE TO CLAIMS OF

DEPOSITORS. 69/ (text capitalized in original)

Because the bank states its belief that these notes are insured to $100,000 per depositor, it is not difficult to understand why note purchasers could be confused as to the insured status of the deposit instruments. Consumers often cannot readily differentiate between insured and uninsured deposit instruments offered by insured financial institutions. Many of the elderly customers of Lincoln Savings and Loan purchased uninsured promissory notes from the institution with the impression that the notes were insured time deposits.

Domestic deposits in large institutions do not fund a major portion of their total assets. For instance, non-deposit liabilities account for one-fifth of the total assets of both Chemical Bank and Security Pacific National Bank (see Table 8). The vast majority of non-deposit liabilities are held by large institutions. These large institutions are increasingly using deposit notes and other deposit-like instruments to avoid deposit insurance assessments. Because these institutions fall under the FDIC's too-big-to-fail policy, these non-deposit liabilities have defacto coverage on these liabilities by the insurance fund, although the banks are not assessed insurance premiums.

The 30 largest commercial banks in the U.S., all of whom have more than $12 billion in assets, held a total of more than $182 billion of non-deposit liabilities as of September 30, 1989 (see Table 9). Non-deposit liabilities represent almost 17 percent of the total liabilities of these institutions. The BIF could receive over $20 billion in assessment income (at the 1990 rate of .12 percent) from these 30 institutions alone if non-deposit liabilities were assessed.

Institutions such as community banks that rarely use collateralized borrowings, deposit notes and other non-deposit liabilities bear a disproportionate share of insurance fund assessments. **The IBAA strongly recommends that the FDIC assess collateralized borrowings, deposit notes and other non-deposit liabilities as a step toward both a more equitable assessment base and the strengthening of the insurance fund.**

3. Multiple Insured Accounts

The IBAA strongly supports the continued insurance of multiple accounts at each institution. Our position is presented in greater detail in the "Scope of Deposit Insurance Coverage" section. Operational considerations and consumer understanding limit the feasibility of restricting each depositor to one insured account per depository institution.

4. Limits on Brokered Deposits

Comments have been specifically requested on limiting brokered deposits. Brokered deposits are one way for a depositor to obtain "pass-through" deposit insurance coverage. Pass-through insurance permits a depositor who places funds with a third party to obtain full coverage (up to $100,000) as an individual, regardless of how many other depositors are joined in the transactions.

First, we believe that the type of accounts that receive pass-through coverage should be considered. For example, brokered deposits are not core deposits and have been used to the detriment of the insurance funds. IBAA strongly supported the provision in FIRREA that prevents undercapitalized institutions from using brokered deposits. This provision has gone a long way towards correcting the abuses of brokered deposits by institutions that paid above-market rates and used this "hot money" to fund risky loans.

On the other hand, unit investment trusts and other qualifying pension funds are much more stable and have not been subject to the same abuses as brokered deposits.

Community bankers also recognize that profit-sharing plans and other trust-like employee benefits plans are becoming the savings mechanism of choice for many consumers. Community bankers must be able to compete for these deposits on the same basis as larger institutions and deposit insurance, including pass-through coverage, is integral to the small bank's competitive position.

Federal deposit insurance is a critical factor in the ability of small banks to attract deposits. **IBAA recognizes that pass-through deposit insurance can enhance a small bank's ability to attract funding. Any reduction or limitation of the pass-through coverage**

could negatively affect those institutions' ability to compete for the pension funds and other deposits which qualify for the coverage.

Given the existence of a class of large institutions that have defacto 100 percent deposit insurance, their support or opposition to pass-through deposit insurance coverage is irrelevant. These large, 100 percent-covered institutions have an advantage over small banks in attracting funding and it is possible that any limitation on pass-through insurance could further impede the small banks' ability to compete. Therefore, the IBAA recommends that the Treasury study include an analysis of the impact that eliminating pass-through deposit insurance could have on small institutions and their ability to compete for funding.

As previously stated, the IBAA retained Market Facts, Inc., to conduct a study of consumer reaction to changes in federal deposit insurance. The study's results are discussed at greater length under the "Incentives to Control Risk" section of this comment letter. However, we are drawing from pertinent parts of the study to respond to the issue of limiting or eliminating brokered deposits.

Consumers indicated that they would change their savings habits if deposit insurance levels were lowered (see Tables 3 and 4). While the majority of the respondents had less than $10,000 in total savings, this would not stop them from changing their habits if deposit insurance coverage were lowered. This leads IBAA to the conclusion that the "perception" of safety is an integral component of deposit insurance and that depositors believe their funds are less safe if coverage is limited. While the IBAA survey did not explicitly address the pass-through coverage, we believe that these results support the need to consider the effect on consumers' perceptions about deposit insurance if pass-through coverage is eliminated or limited.

Consumers were also questioned on whether the size of bank made a difference in how safe they thought their savings were (see Tables 1 and 2). The majority of respondents stated that they felt their savings were equally safe in a large bank as in a small local bank. However, of those that felt size of the institution contributed to safety, three times as many felt their savings were safer in a large bank than a small bank. This result is of concern to community banks. Since small banks do not enjoy too-big-to-fail protection, some consumers have concluded that larger banks have more comprehensive federal deposit insurance coverage.

From this data, IBAA concludes that limitations or elimination of pass-through coverage could have the most deleterious effect on small banks.

IBAA strongly recommends that the Treasury review the competitive benefits that pass-through coverage gives to institutions. The analysis should be broken down by size of institution, so that the effect is considered for both small and large banks. After this analysis is completed, Treasury could then make an informed recommendation regarding pass-through deposit insurance.

D. CREDIT UNIONS

1. Capital Adequacy

Treasury specifically requested comment upon whether capital levels for insured credit unions are adequate and whether the National Credit Union Share Insurance Fund is adequately capitalized, especially in light of the fact that both credit unions and the NCUSIF carry the deposit made with the NCUSIF which is equal to 1 percent of shares on their respective financial statements.

Fortunately, we have not yet seen how the NCUSIF system would work in "a crisis affecting a number of credit unions, or the credit union industry as whole," as Treasury stated in its request for comments. However, if such a crisis did occur -- and the NCUSIF wound up with a negative net worth, as did the FSLIC -- then credit unions would lose their deposit in the NCUSIF which they carry as an asset. This points up the basic flaw in the double-asset treatment: if the money is available to the NCUSIF to close failing credit unions, then it is not available to insured credit unions as an asset.

In a January 1989 study of deposit insurance, the FDIC rejected the idea of requiring thrifts to make a credit union-like, one-time deposit as a way to finance the savings and loan bailout. Not only would this have raised insufficient money, but it would have imposed an additional expense on an already burdened industry, posing "significant long-term risks to the thrifts and their insurer." 70/

More importantly for the present discussion, the FDIC said the NCUSIF system:

> ... has serious shortcomings.... Under this system, insured institutions are permitted to capitalize their contributions, thus having to realize a writedown or writeoff of their contributions if the insurer uses these funds to cover operating losses and expenses. This probably would occur at a time of great difficulty for the industry, the time it least could afford to take any additional losses to capital. Moreover, the insurer would have to ask for an additional contribution from its members or reimpose regular or special insurance assessments,

> either of which would also adversely impact the institutions. (Emphasis added.)
>
> This was the plight of the private deposit guaranty (insurance) funds and their members in the first half of the 1980s. Another problem with this type of insurance system is that the noninsurance-bearing capital contribution generally would be more costly to the insured institutions than the current 8.3 percent insurance assessment. 71/

IBAA believes that credit unions should be required to count the 1 percent deposit as an expense - not an asset. Counting the 1 percent as an asset allows credit unions to overstate their capital strength, thus presenting a false picture of the solvency of the industry. For a well-capitalized credit union, a 1 percent reduction in assets will make no difference -- but for a marginal institution, the 1 percent could make the difference between solvency and failure.

In an April 5, 1989 letter to Rep. Thomas Carper, GAO Assistant Comptroller General Fredrick Wolf said:

> While the [1 percent] deposit appears to meet some of the attributes of an asset as defined by the Financial Accounting Standards Board (FASB), viewed conservatively, the accounting treatment may distort the financial condition of federally insured credit unions.... Therefore, removing the 1 percent capitalization deposit as an asset from the credit unions' books and expensing all future insurance assessments would more fairly present the assets and equity of federally insured credit unions. 72/

Credit unions argue that they may treat the 1 percent deposit as an asset under GAAP because FASB's Statement of Financial Accounting Concepts No. 6 defines assets as "probable economic benefits obtained or controlled by a particular entity as a result of past transactions or events." The future economic benefits include: the annual 1/12 of 1 percent insurance premium, which the NCUA has so far waived because interest on the 1 percent deposit has provided sufficient funding; dividends credit unions earn on the 1 percent deposit; and distributions from the NCUA's equity ratio exceeding 1.3 percent of insured shares. Also, when a solvent credit union withdraws from the NCUSIF, it may recover its deposit.

Nevertheless, treating the 1 percent deposit as an asset is misleading. Although the waived premium and the earned dividends may constitute "future economic benefits" stemming from the 1 percent deposit, they are not the 1 percent deposit itself, and they should be accounted for separately from the 1 percent deposit.

The 1 percent deposit itself does not constitute a "future economic benefit" because credit unions may not withdraw it freely. The deposited 1 percent is not an emergency reserve for a credit union to use in a crisis. Instead, the NCUSIF directs whether, when, and how the 1 percent deposit will be used. Credit unions are required to retain the money on deposit as a condition of NCUSIF membership, and the NCUSIF needs this money to provide the $100,000-per-depositor coverage for all federally insured credit unions. If a credit union fails or goes bankrupt, it does not recover the 1 percent deposit.

Although a solvent credit union may recover the 1 percent upon withdrawal from the NCUSIF, as a practical matter, few credit unions will choose this route. Those which do will probably convert to state insurance funds, which will in turn require a deposit of their own.

Concluding his April 5, 1989 letter to Rep. Carper, Wolf said:

> In fact, the credit unions, in adhering to the requirements of the federal insurance system, have given up control of the 1 percent deposit and in essence have incurred an operating expense. Therefore, counting the deposits as an asset on the credit unions' books may distort the amount of reported assets underlying the equity of the credit unions. From a conservative accounting viewpoint, we believe a clearer picture of the condition of the credit union system would be achieved if credit unions wrote off the deposits from their books and expensed future deposits. 73/

The IBAA agrees with former GAO Assistant Comptroller General Wolf.

The IBAA notes that as originally proposed by the Administration, Section 1101 of the FIRREA bill would have required that credit unions -- like other federally insured depository institutions -- count the money they pay into their insurance fund, the National Credit Union Share Insurance Fund, as an expense, not as an asset. However, credit union industry lobbying defeated this measure.

The Federal Credit Union Act and NCUA regulations implementing the FCUA require federally insured credit unions to maintain a "regular reserve against losses on loans" and other losses. When fully funded, this reserve must consist of at least 6 percent of outstanding loans and risk assets for credit unions with more than $500,000, and 10 percent of outstanding loans and risk assets for credit unions with less than $500,000 in assets.

Also, Article 18 of the standard federal credit union bylaws defines "paid in and unimpaired capital" to be "the balance of the paid-in share accounts as of such date, less any losses that may have been incurred for which there is no reserve or which have not been charged against undivided earnings."

The standard federal credit union bylaws are not official unless a federal credit union's board of directors adopts them -- and they do not impose a minimum capital standard.

No other statute or regulation defines what, if anything else, is included in credit unions' "capital" for regulatory purposes. More statutory guidance would be desirable.

In the January 18, 1990 Federal Register, Treasury amended its original request for comments on its deposit insurance study. The original request stated that both credit unions and the NCUSIF count the 1 percent deposit as an asset. The revision states that although credit unions treat the 1 percent deposit as an asset, the NCUSIF treats it as an equity account. Credit unions count other premiums as expenses, according to the revision.

This mere change in terminology does not change the IBAA's position that credit unions should be required to count the 1 percent deposit as an expense. If the NCUSIF has access to the money to deal with credit union failures, then credit unions do not have access to the money, as they would for legitimate assets.

2. Common Bond Erosion and Lending Limits

The "double-asset" accounting for federally insured credit unions is especially troubling in light of the erosion of credit unions' "common bond" requirement. **A financial institution that opens its doors to all customers should not be eligible for special treatment, including counting its deposit insurance premium as an asset (or, incidentally, freedom from taxation or from the requirements of the Community Reinvestment Act).**

Credit unions were originally created to serve the savings and credit needs of discrete groups of individuals -- for example, the employees of a given factory. Federal law requires federally chartered credit unions to meet a "common bond" test. Some states -- for example, Texas -- impose common bond requirements on state-chartered credit unions.

In July 1989, the NCUA Board passed a final rule defining a "common bond" as individuals "who participate in activities developing common loyalties, mutual benefits, and mutual interests." The NCUA said a "buyers' club," or the customers of a particular insurance company, would not have a sufficient common bond.

Despite credit unions' original purpose, and despite the state and federal laws, many credit unions, some of them federally chartered, admit anyone willing to make a minimal deposit. For example, a November 1988 brochure for Oregonian Federal Credit Union of Portland, Oregon says, "To become a member all you need to do is fill out the necessary paperwork and open a regular share account with a minimum deposit of $5.00. Once you are a member, you are eligible for all the other credit union services." 74/

Construction Equipment Federal Credit Union of Peoria, Illinois offers membership and financing to anyone purchasing a Cellular One portable telephone. 75/

Finally, CUNA Credit Union, of Madison, Wisc., advertises that "Membership is open to all." 76/

Credit unions that do not adhere to a strict common bond should be required to convert to commercial bank charters.

Although their insurance fund is based upon a questionable accounting practice, and their loan committees are often composed of laymen, credit unions enjoy a more liberal lending limit than national banks.

National banks may lend only 15 percent of unimpaired capital and unimpaired surplus to a single borrower, and an additional 10 percent if the debt is fully secured by readily marketable collateral.

Federally chartered credit unions may lend up to 10 percent of their total unimpaired shares and surplus, surplus being defined as undivided earnings. Also, without NCUA board approval, no federally insured credit union may make a business loan to a single borrower greater than 20 percent of its reserves, reserves being defined as undivided earnings, allowance for loan losses, and allowance for lease losses.

"Capital" for a credit union consists of regular reserve transfers, undivided earnings, and special reserves. Total unimpaired shares do not count toward credit unions' capital.

National banks' lending limit is based on capital -- a smaller percentage of their resources than "total unimpaired shares and surplus" is of credit unions' resources.

3. Separating the Chartering Function from the Insurance Function

Comments are requested on whether the NCUA's "regulatory and insurance functions" should be separated. This was a misstatement of the question. **The agency responsible for a depository institution's insurance should also be responsible for at least some of its regulation. However, the agency responsible for chartering credit unions -- thereby promoting them and causing their numbers to increase -- should not also be responsible for regulating and insuring them.**

Several well-qualified observers saw the combination of the chartering and insurance functions in the FHLBB as one of the main reasons behind the collapse of the thrift industry. For example, announcing the publication of the FDIC's study Deposit Insurance for the Nineties - Meeting the Challenge, FDIC Chairman William Seidman said that when deposit insurers become involved with chartering or other issues, "it weakens their resolve to protect the fund." Seidman also said that all three deposit insurance agencies -- including the NCUSIF -- should be self-funded and should be separate from the institutions' chartering authorities. 77/

The credit union industry, and its federal regulator, have opposed splitting the chartering and insurance functions. In testimony before Congress in September 1989, for example, NCUA Chairman Jepsen said that separating the chartering and insurance roles would weaken the NCUA's oversight. 78/

However, one of the main purposes behind FIRREA was to make sure that nothing resembling the savings and loan disaster ever happens again. To further this goal, Congress should separate the chartering and insurance functions for credit unions.

E. INTERRELATIONSHIPS OF REGULATION, FEDERAL DEPOSIT INSURANCE, AND FINANCIAL ACTIVITIES

Comment is requested on the current interrelationships among deposit insurance, regulation, and financial activities; how that interrelationship has evolved; and the appropriate interrelationship for the future.

1. Evolution of Interrelationship

Some of our previous comments have traced the origins of the federal deposit insurance system since its inception in 1933. A corresponding system of regulation, which included limitations on financial activities, developed alongside the deposit insurance system, although much of the bank regulatory structure predated the birth of federal deposit insurance.

Banking has always posed critical public policy issues in the United States and government at all levels has always been involved in bank regulation. The public has always been concerned about where credit flows. In our country's early years, political wars were won and lost over whether there would be an official government bank. One key weapon in the Civil War was the supply of bank credit. The Federal Reserve was created to put an end to periodic money panics which dried up credit.

The question has always been what sectors and what regions would have access to credit: farmers or the cities, the East or the West, the North or the South?

Federal deposit insurance is part of a long line of government involvement in banking. During the Great Depression, local credit dried up. Federal deposit insurance restored stability and ensured that banks in small-town America could survive and provide credit to their communities. Eastern money center banks led the charge against it. The rest of the country demanded it. Deposit insurance remains the key element in the ongoing financial stability of this country and the principal factor buttressing consumer confidence in our financial system.

But deposit insurance was not free; it rested on a tradeoff between banks and the government. A government agency would provide the insurance (paid for by premiums assessed against commercial banks) and bankers were permitted to use deposits to make loans and investments. The government put general limits on the uses of that money (regulation) and would examine banks to make sure that financial institutions engaged in safe and sound banking practices (supervision). Banks had to maintain adequate capital. In short, banks were private businesses -- which enabled them to make independent judgments -- but subject to close scrutiny by the government -- to ensure that the government's interests were protected.

The regulations which accompanied deposit insurance were designed to check the risk-taking activities of banks. A variety of laws, most notably the Glass-Steagall Act, which divorced commercial from investment banking, were passed as further reactions to the stock market crash of 1929 and banking activities both before and after the crash. The Glass-Steagall Act was designed in part to further insulate the deposit insurance system by preventing banks from partaking in what were perceived to be the riskiest of activities. That policy was strengthened over 20 years later by the Bank Holding Company Act of 1956 (BHCA), which "was intended 'to maintain and even to strengthen Glass-Steagall's restrictions on the relationship between commercial and investment banking.'" 79/

The BHCA of 1956 also reaffirmed the states' control over the geographic reach of banking organizations. The Douglas Amendment to the BHCA prohibited interstate bank ownership unless expressly permitted by a state. Earlier, the McFadden Act had set the policy of state control by giving national banks the same branching rights as state-chartered banks.

For some 50 years, the interrelationship between these forces combined to stabilize and reinvigorate the U.S. banking system. Deposit insurance became a natural part of all banking relationships; regulation continued to provide needed control over risk and bank activities and operations; and, with few exceptions, the Glass-Steagall Act, the Douglas Amendment and the McFadden Act, along with other laws, confined the financial activities and geographic scope of banks to their roles as defined since 1933.

The decade of the 1980s has been characterized as a decade of financial revolution. This is an overstatement. There has been substantial change -- some market-driven -- some driven by conscious public policy decisions. This change which brought into play inherent conflicts between deregulation and the government safety net culminated in a massive financial trauma with which our nation is still coping. This industry crisis was and is the failure of a substantial portion of the savings and loan industry and the insolvency of the savings and loan insurance fund.

Past is prologue and a brief review of major public policy decisions over the past 15 years will help reveal the root causes of the savings and loan trauma which undermined the FSLIC safety net and led to this Congressionally mandated study of deposit insurance.

In the late 1970s, inflationary pressures began to plague the United States' economy reflecting earlier macro-economic policy mistakes. Financial institutions making long-term fixed rate loans do not prosper in such an environment. On October 6, 1979 Federal Reserve Chairman Paul Volcker made an historic announcement. The Federal Reserve would no longer target interest rates (specifically the federal funds rate) but rather would seek to control monetary aggregates. Few realized at the time either that this policy decision would drive interest rates to unprecedented levels with a prime rate reaching 20 percent or that it would lead to unprecedented and disruptive extreme interest rate fluctuations. The seeds for a period of financial and economic instability and for the severe recession of 1981-82 arose from this action. These macro-economic developments further undermined the savings and loan industry and led directly to the subsequent breakdown of the FSLIC safety net.

At the same time that the Federal Reserve was trying its new and initially disruptive experiment in monetary policy, the Federal Reserve and the Treasury, working with the Congress, were putting the finishing touches on the most sweeping financial legislation the country had seen since the Great Depression. The historic Depository Institutions Deregulation and Monetary Control Act of 1980 ("1980 Act") set in place the mechanism to decontrol interest rates at the same time it required all depository institutions offering transaction accounts to comply with the Federal Reserve System's mandatory reserve requirements.

The policy prescription for the nation's financial institutions, which were facing increased competition and even disintermediation from money market mutual funds, was deregulation -- which allowed them to pay more for their deposit money. In contrast, the policy prescription for the increasing number of financial institutions leaving the Federal Reserve System to escape sterile reserve requirements which paid no interest was mandatory reserve requirements for all financial institutions.

The increased cost that financial institutions paid for deposits again did not strengthen the financial system and further undermined those financial institutions holding long-term fixed rate assets.

In the 1980 Act, the Congress, with the explicit assent of the FDIC, increased deposit insurance from $40,000 to $100,000 and this $100,000 level has now been in effect for ten years. It has helped determine consumer behavior and financial flows for a decade. It is a very integral part of our existing financial system.

Interest rate deregulation and lifting the deposit insurance cap had an unintended and unforeseen side effect. And it had this side effect because regulators and supervisors were "out" in the early 1980s. Using the colorful terms coined by the head of the Investment Company Institute, "non-cop cops" controlled the regulatory and supervisory beat. David Stockman's OMB worked overtime to cut back funding and personnel at the financial services regulatory agencies at the very time financial institutions were struggling with interest rate deregulation. This was done in a macroeconomic climate of economic and financial instability, record high interest rates and extreme interest rate fluctuations.

As the regulatory non-cop cops looked elsewhere, crooks entered the financial services industry and made a deteriorating situation worse. Since the Treasury Department was leading the charge for financial deregulation, they opposed any attempt by top banking and savings and loan regulators to control the use of brokered deposits. Loose chartering policies, loose supervision, interest rate decontrol and deposit insurance opened the door to massive fraud -- and in turn the collapse of the savings and loan industry and its insurance fund.

Other major policy mistakes which contributed to the savings and loan scandal included Federal Home Loan Bank Board Chairman Richard Pratt's totally misguided reduction of capital requirements on savings and loans at the very time when the opposite policy prescription was called for. In turn, the abortive Garn-St Germain Act.of 1982 ("Garn-StG Act") gave savings and loans new powers that they were ill-equipped to use. The Garn-StG Act also accelerated the interest rate control schedule put in place by the 1980 Act. The policy deemphasis of savings and loan supervision ensured that those ill-equipped to use new powers -- and those equipped to use them fraudulently -- would do maximum damage to the system. Such damage was done and it was left for President Bush and the first session of the 101st Congress to take the first major steps toward cleaning up one of the worst financial messes in the history of the world.

The public policy record also clearly indicates that the 1980 Act and the increase of deposit insurance coverage from $40,000 to $100,000 was not the final chapter in extending this safety net. During the height of the deregulation policy fever in Washington, Continental Illinois was rescued and the federal deposit insurance safety net was extended over all depositors of this major institution, including its foreign depositors, on whose deposits Continental did not pay an insurance assessment. Farther into the decade, the same all-depositors-are-covered blanket was drawn over major Texas banks that were rescued by the government and over the Financial Corporation of America, then the nation's largest thrift. In turn, to ensure that the Black Monday stock market crash didn't turn into a financial panic, the Federal Reserve extended the safety net under the nation's securities industry, promising the industry that they would not lack liquidity. Fed officials played an active role in persuading the nation's financial banks to extend liquidity to America's largest securities firms. This meant that the Fed discount window was fully open to the nation's largest banks.

During this same approximate period, smaller financial institutions, some of which were liquidated, failed in record numbers. The all-depositors-are-covered blanket was not drawn over those institutions. Therefore, depositors perceived that there was some risk in keeping deposits above federal deposit insurance coverage levels in smaller institutions.

In related areas, deregulation in the 1980s meant that the state or federal "licenses" to operate financial institutions were more freely dispensed and markets that were already overbanked became more overbanked. This clearly has safety and soundness ramifications.

On the geographic deregulation front, states took the lead in slowly eroding interstate banking barriers. This was a major movement in the 1980s and almost all states have now opened their boundaries to out-of-state financial institutions. The Congress generally has been content to leave this important area to the states. This has protected states' rights, the dual banking system and financial diversity.

Product deregulation has proceeded at both the state and federal level over the past decade. The breakdown of the savings and loan system has raised questions about the future of product deregulation. Product deregulation can build new risks into the financial system and this in turn could increase the costs of the safety net and the government's financial stake in the system. For example, if large commercial banks had been given the authority to underwrite as well as finance leveraged buyouts, would this have strengthened or further weakened those banks? Many of these banks were reeling under the LDC debt exposure to the detriment of the safety and soundness of the system.

2. Current Interrelationships

Current relationships have been badly strained by the required massive bailout of the FSLIC, looking towards meeting the government's long-standing commitment to protect depositors up to the $100,000 level. The strain is likely to increase as the government moves to further concentrate the financial services industry, using the rationale that this is necessary to make the U.S. financial services industry "internationally competitive." Policy actions that move the U.S. away from its growing debtor nation position probably would do more to make the United States internationally competitive than any other factor.

It is already being argued, primarily by spokesmen of financial institutions which are too-big-to-fail and whose depositors are not at risk, that the federal deposit insurance safety net be cut back. These large banks are actively promoting the position that they be allowed to undertake new and risky activities, and they would accept cutbacks in the federal safety net of deposit insurance. We believe that all small depository institutions and, hopefully, the small businesspersons, farmers and ranchers and domestic consumers they serve, will strongly resist this self-serving policy prescription of the large banks. What would better serve Citicorp's nationwide march to secure deposits than to destroy the deposit-taking capabilities of thousands of smaller financial institutions by cutting existing deposit insurance levels?

This Congressionally mandated study lays the groundwork for the first major public debate of deposit insurance and the federal safety net since the early 1930s. The Administration and the Congress cannot afford to make another major mistake.

3. Appropriate Interrelationships for the Future

There are many lessons to be learned from the collapse of the thrift industry and the resultant insolvency of the FSLIC. It should be the goal of policy makers to draw the right conclusion looking towards constructing a regulatory and supervisory system which balances market forces (deregulation) with safety and soundness in overseeing the financial system.

As we have indicated, the IBAA feels that it is the course of good public policy to err on the side of safety and soundness. We strongly support maintenance and strengthening of the government safety net of existing levels of deposit insurance coverage and access to the Fed discount window tied to the presentation of strong collateral. We strongly support balanced and even-handed regulation applied fairly to competing sectors of the financial services industry. Adequate capital is probably the most important of these regulatory tools. We strongly support an equitable and fair system of ongoing supervision of financial institutions that benefit from the federal safety net, since the full faith and credit of the United States government stands behind our depositors.

We do share New York Federal Reserve Bank President E. Gerald Corrigan's prescription that banks and other depository institutions are special. They create credit and they undergird the smooth functioning of the economy.

The existing level of deposit insurance has been in effect since March 1980. Like it or not, it is an integral component of our financial system, fundamental to maintaining consumer confidence in the system, and essential to the access of smaller institutions to deposit flows at competitive prices. We have ascertained that private deposit insurance is not a viable option. **We do feel that reforms to the existing system should focus on brokered deposits, the fairness of the existing assessment base and very careful change on the deregulation front, and only after it is ascertained that further deregulation is fully**

consistent with safe and sound banking practices and with increased strength and stability of the entire financial system. International competitiveness programs that benefit a relative handful of major institutions to the detriment of thousands of others isn't progress.

We regret that the major institutions of this nation are too-big-to-fail. This creates an ongoing, major inequity. We are willing to discuss various reform proposals once it is proven that any foreign or domestic depositors at very large institutions are at risk. **Smaller depository institutions must be accorded insurance coverage that is not inferior to that enjoyed by the nation's largest financial institutions.** Words and intentions in this area are cheap -- the action of every regulatory and policy official during the 1980s buttressed the doctrine that no depositor is at risk at very large financial institutions. It is worth noting that these policy officials graced the most free market-oriented Administration this country has experienced since the 1920s.

We are not willing to accept on faith that sometime, somewhere down the road depositors at a major U.S. depository institution will be put at risk as depositors over $100,000 are at risk at thousands of smaller financial depositories today.

We are very wary of financial conglomerates and particularly wary of any proposals that further destroy the historic separations between banking and commerce. This does have clear ramifications for the reach of the safety net, including deposit insurance, if firewalls do not provide the necessary protection for the federal safety net.

The IBAA is skeptical that these firewalls would be effective when they are needed the most -- in times of crisis. As a result, banking's federal support system, including deposit insurance and the Federal Reserve's discount window, could be severely strained if the firewalls melted in a crisis.

An obvious example is that of the Continental Illinois Bank during the October 1987 stock market crash. In this case, one regulator was unable to properly police one firewall that it had erected between one bank and one subsidiary. Consider what could happen, for example, if Glass-Steagall is repealed and there are hundreds of banks with full service securities affiliates. If the Comptroller's office was unable to police just one firewall within one banking organization, what confidence should we have that it and other agencies could prevent hundreds of banking institutions from violating the scores of new restrictions they propose when a crisis arises?

A respected commentator has written:

> Given the ability of the financial system to circumvent binding regulation that limits profit, it is not likely that regulatory firewalls, unless they are very thick, will be effective. Thus, the concept of firewalls does not adequately deal with insulating insured deposit services from the more risky underwriting services. 80/

As skeptical as we are that firewalls can work in general, we are convinced that employing them to separate banking from commerce would be far too risky to contemplate. It is hard to imagine a firewall that could withstand the stresses that could be imposed by a failing commercial firm affiliated with a bank holding company. In testimony before Senate Banking Committee, Federal Reserve Chairman Paul Volcker stated:

> What is suggested by some is that strong walls can be built to insulate a regulated and supervised bank from its nonbanking and commercial affiliates. As just indicated, a certain "separateness" is already enforced within a bank holding company. But the insulation is far from complete, and attempting to make it so would present very great practical difficulties.
>
> Common ownership of businesses implies common direction -- why else would they want to join together? In particular, the fortunes of one unit rest on the performance of others, especially in an area so sensitive to confidence as banking.
>
> All our experience with the Bank Holding Company Act points to the strong incentives of management to support all parts of the organization when they come under pressure. That is understandable because it is demonstrable that weakness or failure of one part of a holding company can rapidly spread to others. 81/

Frankly, if a key part of that enterprise is in danger of failing, other parts of that enterprise, including federally-insured banks, would be called upon to rescue the troubled affiliate. In the words of former

Citicorp Chairman, Walter Wriston, "It is inconceivable that any major bank would walk away from any subsidiary of its holding company.... If your name is on the door, all of your capital funds are going to be behind it in the real world." 82/ This could lead to a government rescue of a commercial firm -- the ultimate extension of the too-big-to-fail policy -- and to the endangerment of the deposit insurance system.

To avoid this result, the IBAA recommends a more cautious approach to financial services restructuring. This effort should examine the various facets of the financial business that banks are not already permitted to engage in and determine which could be added without undue regulatory strain. Banks should be permitted to engage in those activities that are closely related to the business in which they are already involved.

Many smaller banks would find it beneficial to both themselves and their customers if they could engage in various retail activities that are financial in nature, such as insurance sales, full service securities brokerage and real estate brokerage. In these cases, they would act as agents for products underwritten by other firms; they would not have an ownership stake in the products and would pose no significant risk to the operation of the bank or to the deposit insurance system.

In addition, some new underwriting activities might safely be given to banks, particularly where they are closely related to their existing business. For example, banks are already permitted to underwrite general obligation municipal bonds, a line of business virtually the same as underwriting municipal revenue bonds which they are not now permitted to do. Similarly, banks cannot underwrite commercial paper, which is a close substitute for traditional commercial loans.

New pressures are adding momentum to radically restructure the financial services industry. Policy makers are now focussing on financial institution reform as a means of remaining internationally competitive in light of the ascendency of foreign financial conglomerates. **It is essential that in considering these issues, fairness (to small banks, for example, which pay a disproportionate share to the insurance fund because the foreign deposits and non-deposit liabilities of large banks are not assessed) and safety and soundness receive the highest priority over the drive to be competitive and to increase market share. If the cost of maintaining the safety and soundness of the deposit insurance system**

means delaying implementation of product diversification until a new regulatory structure is in place, the IBAA believes that it would be worth the wait.

Ten years ago the decisions were being made in Washington which directly contributed to the savings and loan and FSLIC crisis. Let us be very sure that changes recommended to the Congress in 1991 do not lay the seeds for greater financial instability in year 2000. Our unique and highly diversified financial system continues to serve the nation well. States should continue to play an important role in determining what financial structure best serves their needs. And the federal safety net, of which existing levels of deposit insurance are such a key factor, must be protected if consumer confidence is to be maintained and if thousands of smaller depository institutions can continue to compete and meet the financial needs of Main Street America.

Part IV. APPENDICES

APPENDIX A

TABLE 1

INDEPENDENT BANKERS ASSOCIATION OF AMERICA

AUGUST 25-27, 1989

QUESTION 4

FEEL SAVINGS IS SAFER IN A...

		REGION				RACE		EDUCATION			EMPLOYMENT STATUS				PRIMARY	
	TOTAL	NORTH EAST	MID-WEST	SOUTH	WEST	WHITE	NON-WHITE	HIGH SCHL OR <	SOME COL./ GRAD.	POST GRAD.	FULL TIME	PART TIME	RE-TIRED	NOT EM-PLOYD	SHOP-PER	OWN HOME
LARGE STATEWIDE/ NATIONWIDE BANK	186 23.1%	35 21.5%	46 21.6%	56 20.4%	48 31.3%	156 22.6%	30 26.6%	74 19.8%	98 27.2%	15 19.5%	102 21.5%	22 24.7%	33 26.1%	30 25.2%	120 24.6%	119 21.2%
SMALL LOCAL/ COMMUNITY OWNED BANK	70 8.6%	13 8.1%	22 10.0%	18 6.4%	17 11.1%	64 9.2%	6 5.1%	45 12.0%	24 6.6%	1 1.6%	33 7.0%	10 11.6%	14 11.1%	11 9.2%	43 8.8%	52 9.3%
EQUALLY SAFE IN BOTH PLACES	512 63.5%	105 63.9%	137 64.2%	193 70.3%	77 49.8%	439 63.5%	70 62.7%	237 63.3%	223 62.2%	53 70.7%	315 66.3%	55 62.9%	69 54.8%	73 62.3%	306 62.8%	363 64.8%
DOESN'T MATTER/ DON'T CARE	29 3.6%	10 5.8%	8 3.8%	4 1.3%	8 5.1%	24 3.5%	5 4.1%	13 3.5%	10 2.8%	6 8.2%	20 4.2%	1 .8%	6 4.7%	3 2.3%	15 3.1%	22 3.9%
DON'T KNOW	10 1.2%	1 .7%	1 .4%	4 1.4%	4 2.7%	8 1.2%	2 1.6%	6 1.5%	4 1.2%	-	5 1.0%	-	4 3.3%	1 .9%	3 .7%	5 .9%
REFUSED/NO ANSWER	4	1	-	2	-	4	-	-	1	3	3	-	1	-	2	4
ANALYZED WEIGHTED RESPONDENTS	807 100.0%	165 100.0%	214 100.0%	274 99.8%	154 100.0%	692 100.0%	112 100.1%	374 100.1%	358 100.0%	75 100.0%	475 100.0%	87 100.0%	126 100.0%	117 99.9%	488 100.0%	561 100.1%

Reprinted from: Telenation Report - Data Collected August 25-27, 1989, V.I General Population for "Study of Consumer Reaction to Changes in Federal Deposit Insurance" prepared by Market Facts, Inc. for the Independent Bankers Association of America.

TELENATION
A SERVICE OF MARKET FACTS, INC.

TABLE 2

AUGUST 25-27, 1989

INDEPENDENT BANKERS ASSOCIATION OF AMERICA

QUESTION 4

FEEL SAVINGS IS SAFER IN A...

		*--SEX---	*	*-------------	------------AGE	-------------	-------------	-------------*	*--------	--------	-INCOME-	--------	---------*	*MARITAL * *-STATUS-		*CHILD
				18	25	35	45	55			15K	25K	40K			
			FE-	TO	TO	TO	TO	TO			TO	TO	TO		MAR-		IN
	TOTL	MALE	MALE	24	34	44	54	64	65+	<15K	<25K	<40K	<50K	50K+	RIED	OTHR	HH
	----	----	----	--	--	--	--	--	---	----	----	----	----	----	----	----	--
LARGE STATEWIDE/ NATIONWIDE BANK	186 23.1	91 23.1	95 23.0	32 30.5	65 30.0	31 18.4	15 13.4	23 24.3	20 17.8	28 21.9	29 19.6	59 26.5	20 17.3	50 25.9	119 22.5	67 24.1	80 22.8
SMALL LOCAL/ COMMUNITY OWNED BANK	70 8.6	27 6.9	42 10.2	5 5.0	9 4.2	17 9.8	13 11.9	8 8.9	17 15.4	19 15.0	14 9.4	18 8.3	7 5.7	12 6.1	47 8.8	23 8.3	27 7.8
EQUALLY SAFE IN BOTH PLACES	512 63.5	252 64.1	260 62.9	65 62.0	136 62.7	116 68.5	74 67.3	58 62.7	62 55.6	70 55.4	97 65.6	135 60.5	87 74.7	124 63.7	340 64.1	172 62.3	233 66.7
DOESN'T MATTER/ DON'T CARE	29 3.6	20 5.0	9 2.2	1 1.1	7 3.1	5 2.7	8 7.3	2 2.6	6 5.5	6 4.7	5 3.5	8 3.7	3 2.3	7 3.6	18 3.4	11 3.9	9 2.5
DON'T KNOW	10 1.2	3 .8	7 1.6	1 1.0	-	1 .6	-	1 1.5	6 5.7	4 3.0	3 1.8	2 1.0	-	1 .7	6 1.2	4 1.4	1 .3
REFUSED/NO ANSWER	4	3	1	-	-	1	1	1	-	-	-	-	-	4	4	-	3
ANALYZED WEIGHTED RESPONDENTS	807 100.0	393 99.9	414 99.9	105 100.0	217 100.0	170 100.0	110 99.9	93 100.0	112 100.0	126 100.0	148 99.9	222 100.0	116 100.0	194 100.0	530 100.0	278 100.0	350 100.1

Reprinted from: Telenation Report - Data Collected August 25-27, 1989, V.I General Population for "Study of Consumer Reaction to Changes in Federal Deposit Insurance" prepared by Market Facts, Inc. for the Independent Bankers Association of America.

TELENATION
A SERVICE OF MARKET FACTS, INC.

TABLE 3

Federal Insurance Limits Which Would Change Savings Behavior

		Region					Primary Institution		
	General Population %	Northeast %	Midwest %	South %	West %	Individuals with Savings 50K+ %	Bank %	Savings & Loan %	Credit Union %
$90,000	22	23	22	23	18	39	20	19	28
$75,000	11	9	10	12	11	17	10	13	13
$50,000	16	10	18	18	14	19	15	17	17
None of the above	50	58	49	45	53	23	52	51	38
Don't know	1	*	1	2	4	2	3	--	4
(BASE)	(836)	(173)	(237)	(300)	(126)	(251)	(538)	(141)	(132)

* Less than 0.5%

Source: Questions 7, 8, 9

Reprinted from: Study of Consumer Reaction to Changes in Deposit Insurance prepared by Market Facts, Inc. for the Independent Bankers Association of America, September 21, 1989.

TABLE 4

How Limit Reduction Would Change How Much or Where One Saves[1]

	General Population %	Individuals With Savings $50K+ %
Distribute Savings Across Institutions	58	80
Keep Less Money in Savings Account/Bank	18	18
Move Money into a Money Market Account or other Investment	3	3
Other	6	*
Don't know	16	5
(BASE)	(387)	(186)

* Less than 0.5%

Source: Questions 7a, 8a, 9a

Reprinted from: Study of Consumer Reaction to Changes in Deposit Insurance prepared by Market Facts, Inc. for the Independent Bankers Association of America, September 21, 1989.

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[1] **Table includes multiple mentions**

TABLE 5

BANK INSURANCE FUND RESERVES:
ONLY DOMESTIC DEPOSITS ASSESSED

(in billions of dollars)

Bank Insurance Fund reaches 1.25 target reserve level in 1993 as currently measured against insured deposits.

Bank Insurance Fund reaches 1.25 target reserve level in 1995 if measured against total domestic deposits.

	1988	1989	1990	1991	1992	1993	1994	1995
PREMIUM ASSESSMENT	0.083	0.083	0.12	0.15	0.15	0.15	0.15	0.15
TOTAL DOMESTIC DEPOSITS	2,331	2,448	2,570	2,698	2,833	2,975	3,124	3,280
TOTAL INSURED DEPOSITS	1,750	1,836	1,927	2,024	2,125	2,231	2,343	2,460
ASSESSMENT INCOME	1.77	2.03	3.08	4.05	4.25	4.46	4.69	4.92
INVESTMENT INCOME	1.57	1.12	1.14	1.27	1.54	1.88	2.31	2.79
TOTAL INCOME	3.34	3.16	4.22	5.32	5.79	6.35	7.00	7.71
TOTAL INCOME	3.34	3.16	4.22	5.32	5.79	6.35	7.00	7.71
EXPENSES	7.59	3.00	2.50	2.00	1.50	1.00	1.00	1.00
NET INCOME	(4.25)	0.16	1.72	3.32	4.29	5.35	6.00	6.71
TOTAL FUND RESERVES	14.06	14.22	15.94	19.26	23.55	28.90	34.89	41.61
COVERAGE RATIO OF INSURED DEPOSITS	0.83	0.77	0.83	0.95	1.11	1.30	1.49	1.69
COVERAGE RATIO OF TOTAL DOMESTIC DEPOSITS	0.60	0.58	0.62	0.71	0.83	0.97	1.12	1.27

Assumptions:
5% annual growth in assessable deposits
insured deposits/total deposits = 75%
FDIC investment yield on Treasuries = 8%

Source for 1988 figures on domestic and insured deposits, assessment and investment income, expenses and total fund reserves: FDIC 1988 ANNUAL REPORT

TABLE 6

BANK INSURANCE FUND RESERVES:
DOMESTIC AND FOREIGN DEPOSITS AND NON-DEPOSIT LIABILITIES ASSESSED

(in billions of dollars)

Insurance Fund Reaches 1.25 Optimal Target Level in 1996

	1989	1990	1991	1992	1993	1994	1995	1996
PREMIUM ASSESSMENT	0.083	0.12	0.15	0.15	0.15	0.15	0.15	0.15
LIABILITIES								
FOREIGN DEPOSITS	331	344	358	372	387	403	419	436
OTHER LIABILITIES	220	231	243	255	267	281	295	310
SUBTOTAL	551	575	601	627	655	683	714	745
DOMESTIC DEPOSITS	2,350	2,468	2,591	2,720	2,856	2,999	3,149	3,307
TOTAL ASSESSABLE BASE	2,901	3,043	3,191	3,347	3,511	3,683	3,863	4,052
ASSESSMENT INCOME								
DOMESTIC DEPOSIT INC.	1.95	2.96	3.89	4.08	4.28	4.50	4.72	4.96
FOREIGN DEP. INCOME		0.413	0.537	0.558	0.581	0.604	0.628	0.653
OTHER LIABILITY INC.		0.277	0.364	0.382	0.401	0.421	0.442	0.464
SUBTOTAL	1.95	3.65	4.79	5.02	5.27	5.52	5.79	6.08
INVESTMENT INCOME	1.12	1.13	1.31	1.64	2.05	2.55	3.12	3.75
TOTAL INCOME	3.07	4.78	6.09	6.66	7.31	8.08	8.91	9.83
EXPENSES	3.00	2.50	2.00	1.50	1.00	1.00	1.00	1.00
NET INCOME	0.07	2.28	4.09	5.16	6.31	7.08	7.91	8.83
FUND RESERVES	14.07	16.35	20.44	25.60	31.91	38.99	46.90	55.73
COVERAGE RATIO OF TOTAL ASSESSABLE BASE	0.49	0.54	0.64	0.76	0.91	1.06	1.21	1.38
FDIC FUND YE 1988	14.00							

ASSUMPTIONS:		
	ANNUAL DEPOSIT GROWTH	5%
	FOREIGN DEPOSIT GROWTH	4%
	OTHER LIABILITIES GROWTH	5%
	INVESTMENT YIELD - TREASURIES	8%

Source for 1989 figures: FDIC Office of Research and Statistics

TABLE 7

PROJECTED INCOME FROM FOREIGN DEPOSIT ASSESSMENT

	1990	1991	1992
Premium Assessment	0.12	0.15	0.15
Foreign Deposits With Growth At 5 Percent	348	365	383
Income to the Bank Insurance Fund	0.417	0.547	0.575
Foreign Deposits With No Growth	331	331	331
Income to the Bank Insurance Fund	0.397	0.497	497
Foreign Deposits With Growth At -5 Percent	314	299	284
Income to the Bank Insurance Fund	0.377	0.448	0.426
Foreign Deposits With Growth At -10 Percent	298	268	241
Income to the Bank Insurance Fund	0.357	0.402	0.426

TABLE 8

BIF ASSESSMENT INCOME FROM DOMESTIC AND FOREIGN DEPOSITS AND NON-DEPOSIT LIABILITIES OF THE 30 LARGEST COMMERCIAL BANKS

(in millions of dollars)

If the foreign deposits and non-deposit liabilities of these too-big-to-fail banks were assessed, over $550 million of additional funds ($355 million from foreign deposits; $219 million from non-deposit liabilities) would be added to the Bank Insurance Fund to cover these de facto liabilities.

BANK NAME TO FDIC	TOTAL ASSETS	DOMESTIC DEPOSITS	INCOME TO FDIC	FOREIGN DEPOSITS	INCOME TO FDIC	NON-DEPOSIT LIABILITIES	INCOME TO FDIC	TOTAL INCOME
Citibank	158,535	43,536	52.24	65,849	79.02	20,632	24.76	156.02
Bank of America	84,755	51,284	61.54	19,143	22.97	6,028	7.23	91.75
Chase Manhattan Bank	82,711	27,987	33.58	32,882	39.46	10,885	13.06	86.10
Morgan Guaranty Trust	65,164	7,626	9.15	33,562	40.27	11,217	13.46	62.89
Security Pacific NB	56,724	31,075	37.29	6,981	8.38	11,214	13.46	59.12
Manufacturers Hanover	55,016	23,125	27.75	19,069	22.88	6,633	7.96	58.59
Bankers Trust Co.	50,314	12,842	15.41	18,663	22.40	7,663	9.20	47.00
Chemical Bank	49,353	25,602	30.72	8,399	10.08	10,586	12.70	53.50
Wells Fargo Bank	45,408	34,022	40.83	256	0.31	7,038	8.45	49.58
First NB of Chicago	37,724	12,895	15.47	14,526	17.43	7,558	9.07	41.97
Continental Bank	31,621	12,510	15.01	6,600	7.92	9,199	11.04	33.97
NCNB Texas NB	29,470	20,737	24.88	1,316	1.58	5,602	6.72	33.19
The Bank of New York	27,656	12,906	15.49	8,919	10.70	3,937	4.72	30.91
First NB of Boston	27,107	11,840	14.21	6,096	7.32	6,400	7.68	29.20
Irving Trust Co.	23,563	6,768	8.12	10,026	12.03	3,540	4.25	24.40
Mellon Bank	22,563	11,354	13.62	4,092	4.91	5,440	6.53	25.06
Marine Midland Bank	21,605	14,069	16.88	3,371	4.05	2,917	3.50	24.43
Republic NB of NY	21,363	5,592	6.71	9,058	10.87	3,821	4.59	22.17
First Interstate	20,780	16,223	19.47	1,187	1.42	1,594	1.91	22.80
NCNB of N. Carolina	18,085	10,468	12.56	1,210	1.45	5,087	6.10	20.12
First Union NB of NC	17,977	9,383	11.26	532	0.64	7,069	8.48	20.38
Ntl Bank of Detroit	16,410	10,714	12.86	1,467	1.76	3,115	3.74	18.36
Pittsburgh NB	15,967	9,755	11.71	350	0.42	4,855	5.83	17.95
Union Bank	15,782	10,501	12.60	675	0.81	3,233	3.88	17.29
Wachovia B & T	14,974	11,169	13.40	336	0.40	2,456	2.95	16.75
Bank of New England	14,681	7,499	9.00	1,618	1.94	4,025	4.83	15.77
Southeast Bank	14,317	9,854	11.82	953	1.14	2,699	3.24	16.21
Ntl Westminster	14,241	10,005	12.01	1,709	2.05	2,027	2.43	16.49
First Bank	13,305	8,669	10.40	665	0.80	2,944	3.53	14.73
Sovran Bank	13,272	9,652	11.58	100	0.12	2,681	3.22	14.92
TOTAL	1,080,443	489,662	587.59	279,610	335.53	182,095	218.51	1,141.64

*0.12 Percent is used as the assessment rate

*figures are as of September 30, 1989 from the FDIC Office of Research and Statistics

TABLE 9

POTENTIAL INCOME TO THE BANK INSURANCE FUND FROM THE 30 LARGEST COMMERCIAL BANKS

($ millions)

If assessments were collected on all liabilities,
the income to the Bank Insurance Fund would be increased by $555 million.

		ANNUAL INCOME TO FDIC	
	TOTAL LIABILITY	CURRENT	POTENTIAL
DOMESTIC DEPOSITS	$489,662	$588	$588
FOREIGN DEPOSITS	$279,610	$0	$336
NON-DEPOSIT LIABILTIES	$182,095	$0	$219
TOTAL	$951,367	$588	$1,143

Based on 1990 premium assessment rate of 0.12 percent
Source: FDIC Office of Research and Statistics
Figures are as of September 30, 1989.
See Table 8 for detail.

APPENDIX B

FOOTNOTES

1. Golembe, Deposit Insurance, Political Science Quarterly, June 1960, at 182.
2. Ibid., at 187.
3. Federal Deposit Insurance Corp., FDIC: The First Fifty Years 31 (1984).
4. Ibid., at 36.
5. Ibid., at 38.
6. Ibid.
7. Ibid., at 40.
8. Ibid., at 40-41.
9. Ibid., at 41-43.
10. Ibid.
11. Ibid.
12. Ibid., at 44.
13. Ibid.
14. Ibid.
15. H.R. Conf. Rep. No. 742, 74th Cong., 1st Sess., at 2 (1935).
16. Ibid.
17. Federal Deposit Insurance Corp.,FDIC: The First Fifty Years, 69 (1984).
18. Cong. Rec. 3837 (1933) (statement of Rep. Steagall).
19. Ibid., at 3729.
20. Hearings on S. 3603 Before the Senate Comm. on Banking and Currency, 73rd Congress, 2nd Sess. 33 (1934) (statement of John H. Fahey, Chairman of the Federal Home Loan Bank Board).

21. Federal Home Loan Bank Board, A Guide to The Federal Home Loan Bank System, 47 (1987).

22. Ibid., at 47.

23. Ibid., at 48.

24. Ibid.

25. Ibid.

26. National Credit Union Administration, 1970 Annual Report iii-iv.

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APPENDIX D

STUDY OF CONSUMER REACTION TO CHANGES IN FEDERAL DEPOSIT INSURANCE

Presented to:

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TABLE OF CONTENTS

I. INTRODUCTION 1

  A. Background and Objectives 1

  B. Methods 1

  C. Analysis 2

  D. Weighting 3

II. FINDINGS 4

  A. Types of Institutions and Amount in Savings 4

  B. Safety of Institutions 7

  C. Effects of Changes in Federal Insurance 15

APPENDIX

Questionnaire

I. INTRODUCTION

A. Background and Objectives

As part of a larger study of possible regulatory changes, the Independent Bankers Association of America retained the services of Market Facts, Inc. to conduct a telephone survey of consumers who have accounts with depository institutions to determine how consumers view deposit insurance, what their perceived reactions are to reducing the ceiling for insured deposits, and reactions to sharing the loss if an institution fails. The survey was conducted among a nationally representative sample of adults 18 and over who have either a savings, checking, money market account, IRA or CD with a bank, savings and loan, or credit union. In order to provide a large enough sample of respondents with large deposits ($50,000+), the national probability interviews were supplemented with a sample of higher income respondents (household income of $50,000+).

B. METHODS

The Independent Bankers Association of America submitted twelve questions (see Appendix) to TeleNation, Market Facts' weekly omnibus telephone survey through which a nationally representative sample of 1,000 adults is interviewed each weekend. A total of 838 respondents qualified for the IBAA survey by having either a savings, checking, or money market account, an IRA, or a CD with a bank, savings and loan, or a credit union. The TeleNation questions were administered August 25-27, 1989.

From a database of previous TeleNation surveys, a sample of 413 individuals with household incomes of $50,000+ was administered the identical questionnaire in an effort to boost the number of cases with deposits of $50,000+. These telephone interviews were conducted from August 25-30,1989.

C. ANALYSIS

In the tables that appear in the findings, results are presented for the general population as a whole as well as for various subgroups (e.g. region, type of primary financial institution, and size of bank), when relevant. Because it was believed that individuals with deposits of $50,000+ would have different opinions than the general population, a further breakdown by this variable is also presented and discussed where relevant. For the most part, differences across subgroups are pointed out in the accompanying text only if they are statistically significant.

The following tables are provided as an easy reference for determining the statistical accuracy of proportions (at the 95% level of confidence), both within a single sample and between two independent samples.

Within a Single Sample*

	Approximate Magnitude of Results				
Approximate Sample Size	10% 90%	20% 80%	30% 70%	40% 60%	50% 50%
100	6	8	9	10	10
200	4	6	6	7	7
400	3	4	5	5	5
600	2	3	4	4	4
1000	2	3	3	3	3

* Observed percent ± the appropriate number shows by how much the observation could vary due to sampling error.

Between Two Independent Samples*

Approximate Sample Size	Approximate Magnitude of Results 10% 90%	20% 80%	30% 70%	40% 60%	50% 50%
100	8	11	13	14	14
200	6	8	9	10	10
400	4	6	6	7	7
600	3	5	5	6	6
1000	3	4	4	4	4

* Minimum difference required between the observed percents in the two sampled populations to be statistically different.

D. WEIGHTING

The general population data which serve as the basis for this report have been weighted to reflect national estimates with regard to gender, age, income, and region.

II. FINDINGS

A. Types of Institutions and Amount in Savings

Over eight in ten adults say they have either a savings, checking, or money market account, an IRA or a CD with a bank, savings and loan or credit union. This eight-two percent represents the base of "depository customers" in the general population for the study. These customers were asked to describe their primary institution and to indicate the dollar range into which their total savings falls.

- Nearly two thirds (64 percent) of depository customers name a bank as the primary financial institution where they have most of their money, whereas less than one-fifth name either a savings and loan (17 percent) or a credit union (18 percent -- Table 1).
- Although the majority of customers regard a bank as their primary institution, some regional preferences emerge: banks are most preferred in the Northeast where more than three-fourths (76 percent) name a bank as their primary financial institution whereas they are less preferred in the West where only one-half (50 percent) claim a bank as their primary institution.
- Preferences for credit unions are strongest in the South and preferences for savings and loans are more concentrated in the West. One fourth (25 percent) of Southerners name a credit union as their primary financial institution and twenty-eight percent of Western customers say a savings and loan is the institution where they have most of their money.
- Although within the general population savings and loans and credit unions are named by equal proportions as the primary savings institution, among individuals with savings of $50,000 or more, savings and loans (22 percent) are more often named than credit unions (15 percent -- Figure 1).

TABLE 1

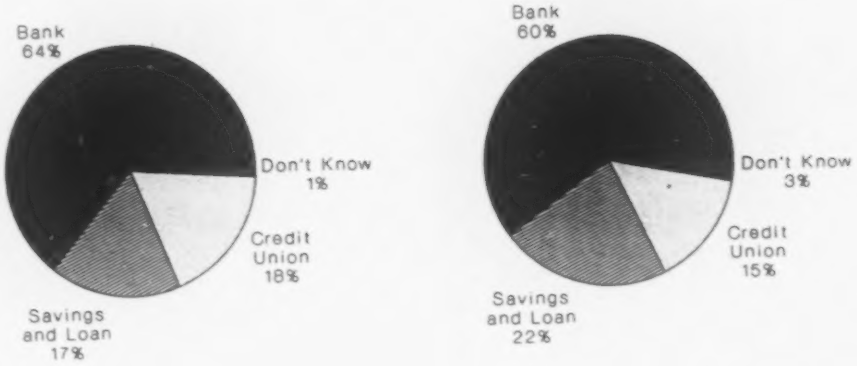
Type of Primary Financial Institution

	General Population %	Region: Northeast %	Midwest %	South %	West %	Individuals with Savings 50K+ %
Bank	64	76	68	61	50	60
Credit Union	18	6	16	25	21	15
Savings and Loan	17	15	15	14	28	22
Don't know	1	3	2	*	1	3
(BASE)	(825)	(170)	(236)	(295)	(124)	(246)

* Less than 0.5%

Source: Question 2

Figure 1
Type of Primary Financial Institution



General Population
n=825

Individuals with Savings of 50k+
n=246

- When those whose primary institution is a bank were asked whether their bank was a small local or community owned bank or a large statewide or nationwide bank, more than one-half (57 percent) indicated that it is a large statewide or nationwide bank. Westerners (85 percent) are significantly more likely than others to say theirs is a large bank. Moreover, people with large savings ($50,000+) are slightly more likely to say that their bank is a large one (65 percent -- Table 2).

- Nearly one-half (48 percent) of the respondents reported having under $10,000 in total current savings; twenty-eight percent reported having between $10,000 and $50,000; seventeen percent reported having more than $50,000 and eight percent either refused to give an amount or were unsure (Table 2A).

- Customers who claim a savings and loan as their primary institution report higher savings amounts than those with money in a bank or credit union. Only thirty-six percent of those whose primary institution is a savings and loan said they have under $10,000 in savings, compared to fifty percent of those who use a bank and fifty-six percent of those who use a credit union.

B. Safety of Institutions

In an effort to ascertain perceptions about the safety of money in various size and types of financial institutions, respondents were asked whether they feel their savings are safer in a large statewide or nationwide bank or in a small local or community owned bank. They were also asked whether they believe Federal Deposit Insurance makes their money safer at a bank, credit union or savings and loan and whether the type of Federa Deposit insurance affects their decision to select a particular type of institution.

- The majority (67 percent) believe savings would be equally safe in both a large and small bank. However, the size of a financial institution clearly influences some people's perceptions as nearly one-quarter (23 percent) indicated that they believe their money would be safer in a large statewide or nationwide bank while only nine percent think theirs would be safer in a small local or community owned bank (Table 3).

TABLE 2

Bank Size

	General Population %	Region				Individuals with Savings 50K+ %
		Northeast %	Midwest %	South %	West %	
Large Statewide/ Nationwide Bank	57	54	46	56	85	65
Small Local/Community Owned Bank	43	47	53	44	15	34
(BASE[1])	(537)	(126)	(158)	(187)	(66)	(147)

Source: Question 3

---

[1] Base only includes people whose primary financial institution is a bank.

TABLE 2A

Total Amount Currently in Savings

		Region					Primary Institution		
	General Population %	Northeast %	Midwest %	South %	West %	Individuals with Savings 50K+ %	Bank %	Savings & Loan %	Credit Union %
Under $10,000	48	44	49	46	54	-	50	36	56
$10,000 <$50,000	28	32	29	25	27	-	26	35	30
$50,000 <$75,000	7	8	5	7	8	40	6	9	6
$75,000 <$100,000	4	5	4	5	3	23	4	4	4
$100,000+	6	5	7	7	3	37	5	10	3
Don't know	3	*	2	5	*	-	4	1	-
Refused	5	5	6	4	5	-	5	5	1
(BASE)	(838)	(173)	(239)	(300)	(126)	(251)	(539)	(141)	(133)

* Less than 0.5%

Source: Question 13

TABLE 3

Perceptions About the Safety of Money in Different Size Banks

	General Population %	Region				Individuals with Savings 50K+ %
		Northeast %	Midwest %	South %	West %	
Safer in a Large Statewide/ Nationwide Bank	23	22	22	20	31	23
Safer in Small Local/ Community Owned Bank	9	8	10	6	11	10
Equally Safe in Both Places/Doesn't Matter	67	70	68	72	55	66
Don't know	1	1	*	1	3	1
(BASE)	(825)	(172)	(239)	(298)	(126)	(249)

* Less than 0.5%
Source: Question 4

- While the amount in one's savings account does not have any bearing on one 's perception about the safety of money in a small versus a large institution, region of the country does. Westerners appear to hold large banks in higher regard than people in other parts of the country as nearly one-third of the respondents from the West (31 percent) said they believe savings would be safer in a large statewide or nationwide bank compared to eleven percent who feel they would be safer in a small bank and fifty-five percent who said the size of the bank wouldn't matter.

- Similarly, a majority (74 percent) of depository customers agree that Federal Deposit Insurance makes money equally safe in a bank, savings and loan, or a credit union. Nearly one-fifth (18 percent) believe that it is safer at a bank while three percent believe it is safer at a credit union, and two percent think it would be safer at a savings and loan. Three percent admitted that they do not know where it would be safest (Table 4 and Figure 2).

- Consistent with previous findings, Northeasterners are more likely than others to think that their money would be safest at a bank with Federal Deposit Insurance (27 percent in the Northeast versus 18 percent or less in other regions). In the West respondents were most likely to say that savings are equally safe in all three institutions (84 percent).

- More than four in ten (45 percent) agree that the type of Federal insurance covering banks, savings and loans, and credit unions affects their decision as to the type of institution they use for savings with agreement higher in the South (53 percent) and lower in the Northeast (34 percent -- Table 5).

- Individuals with savings of $50,000 and above are more sensitive than those with lower savings to the type of Federal insurance being offered as fifty-eight percent of those with this level of savings claimed that the type of Federal insurance covering an institution affects their selection decision.

TABLE 4

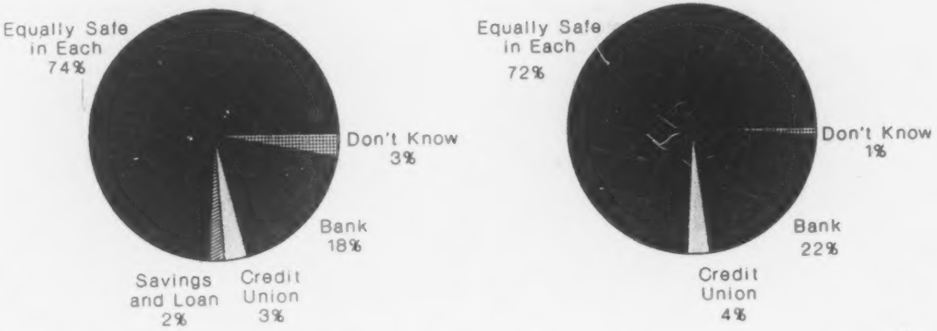
Perceptions About the Safety of Money at Different Types of Institutions With Federal Deposit Insurance

	General Population %	Region Northeast %	 Midwest %	 South %	 West %	Individuals with Savings 50K+ %
Safer at a Bank	18	27	16	18	12	22
Safer at a Savings and Loan	2	4	3	1	2	–
Safer at a Credit Union	3	4	2	4	2	4
Equally Safe in Each/ Doesn't Matter	74	60	77	74	84	72
Don't know	3	6	2	3	1	1
(BASE)	(825)	(173)	(238)	(299)	(126)	(250)

Source: Question 5

Figure 2

Perceptions About Safety of Money at Different Types of Institutions with Federal Deposit Insurance



General Population
n=825

Individuals With Savings of 50k+
n=250

TABLE 5

Whether Type of Federal Insurance Coverage Affects Type of Financial Institution Chosen

	General Population	Region				Individuals with Savings 50K+
		Northeast	Midwest	South	West	
	%	%	%	%	%	%
Yes	45	34	46	53	40	58
No	53	65	51	46	57	42
Don't know	2	1	3	1	3	–
(BASE)	(836)	(171)	(239)	(300)	(126)	(250)

Source: Question 6

C. Effects of Changes in Federal Insurance

The Federal government now fully insures depositors up to $100,000 at each depository institution. Respondents were asked whether a reduction in this ceiling, a 10 percent required deductible, or co-insurance would affect how much or where they saved.

1. Effects of Limits on Insurance

- More than one-fifth (22 percent) of the general population of depositors claim that a $10,000 reduction in the amount of deposit insurance guaranteed by the Federal government would affect how much or where they saved. Another eleven percent claim a $25,000 reduction would affect their savings behavior and sixteen percent profess that a $50,000 reduction would alter their behavior. One-half (50 percent) of the population suggest that as long as the limit does not go below $50,000, there would be no impact on how much or where they save. (Table 6).

- It appears that limiting the ceiling on insurance provided by the federal government will have a more dramatic impact on the savings behavior of those with large deposits. Nearly four in ten persons (39 percent) with savings of $50,000 and over claimed that they would change their savings behavior if the insurance limit were dropped to $90,000. In fact, only twenty-three percent of those with $50,000 or more in savings said they would not change their behavior at either a $90,000, $75,000 or $50,000 limit (Figure 3).

- Distributing savings across institutions would be the most prevalent change in behavior resulting from reduced insurance limits (Table 6A). Fifty-eight percent of those who said they would alter how much or where they save said that a limit in the coverage would cause them to distribute their savings across institutions. Eighteen percent said that a reduction would cause them to keep less money in a savings account, and three percent said that a limit on the insurance would motivate them to move money into a money market account or another investment. Nearly one in six (16 percent) admit that they do not know what they would do if the limits dropped.

TABLE 6

Federal Insurance Limits Which Would Change Savings Behavior

		Region					Primary Institution		
	General Population %	Northeast %	Midwest %	South %	West %	Individuals with Savings 50K+ %	Bank %	Savings & Loan %	Credit Union %
$90,000	22	23	22	23	18	39	20	19	28
$75,000	11	9	10	12	11	17	10	13	13
$50,000	16	10	18	18	14	19	15	17	17
None of the above	50	58	49	45	53	23	52	51	38
Don't know	1	*	1	2	4	2	3	–	4
(BASE)	(836)	(173)	(237)	(300)	(126)	(251)	(538)	(141)	(132)

* Less than 0.5%

Source: Questions 7, 8, 9

TABLE 6A

How Limit Reduction Would Change How Much or Where One Saves[1]

	General Population %	Individuals With Savings $50K+ %
Distribute Savings Across Institutions	58	80
Keep Less Money in Savings Account/Bank	18	18
Move Money into a Money Market Account or other Investment	3	3
Other	6	*
Don't know	16	5
(BASE)	(387)	(186)

* Less than 0.5%

Source: Questions 7a, 8a, 9a

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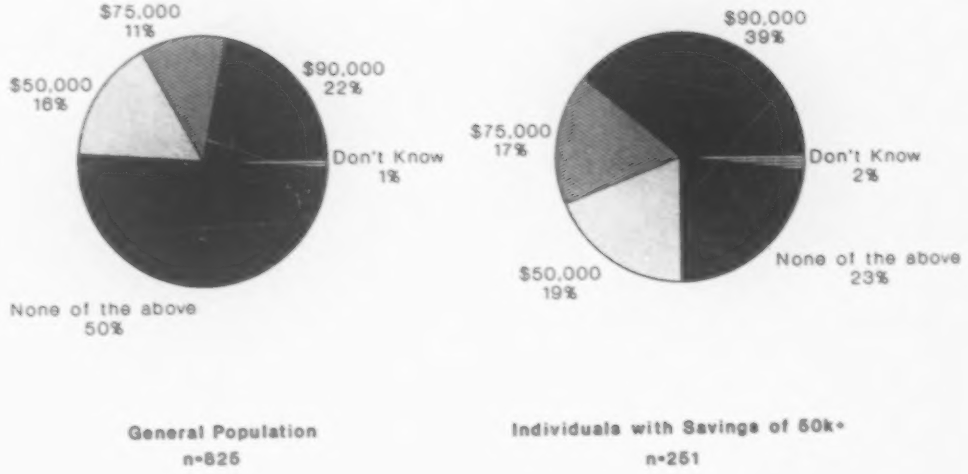
[1] Table includes multiple mentions

Figure 3
Federal Insurance Limits Which Would Change Savings Behavior



- Large depositors ($50,000+) are less likely to say they "don't know" (5 percent versus 16 percent) what they would do if faced with a reduction in coverage and more likely to say they would distribute their savings across institutions (80 percent versus 58 percent).

2. Effects of 10% Deductible

- Two-thirds (67 percent) of the general population maintain that if Federal insurance only covered 100% of losses up to $10,000 in deposits if the bank failed, and customers were required to cover 10% of any losses between $10,000 and $100,000 they would change how much or where they saved. This attitude did not vary significantly across region. However, again, large depositors were even more likely (83 percent) to indicate a change in their saving behavior (Table 7, Figure 4).

3. Effects of Co-Insurance

- A co-insurance alternative does not appear to be as disturbing to consumers as the deductible option as slightly less than one-half (45 percent) indicate that they would change their savings behavior if the Federal government shared the insurance responsibility with a private company whereby the government insures depositors up to $50,000 and private companies insure bank depositors for amounts over $50,000 (Table 8 and Figure 5) However, individuals with savings of $50,000 and above and consumers in the West, are more likely than the general population to say their savings would be affected by co-insurance (59 percent and 54 percent respectively.)

- Again, distributing savings across institutions was the most frequently mentioned response (46 percent) to how co-insurance would affect one's behavior, followed by keeping less money in savings accounts (18 percent) and analyzing the private firm that would be insuring amounts over $50,000 (12 percent -- Table 8A).

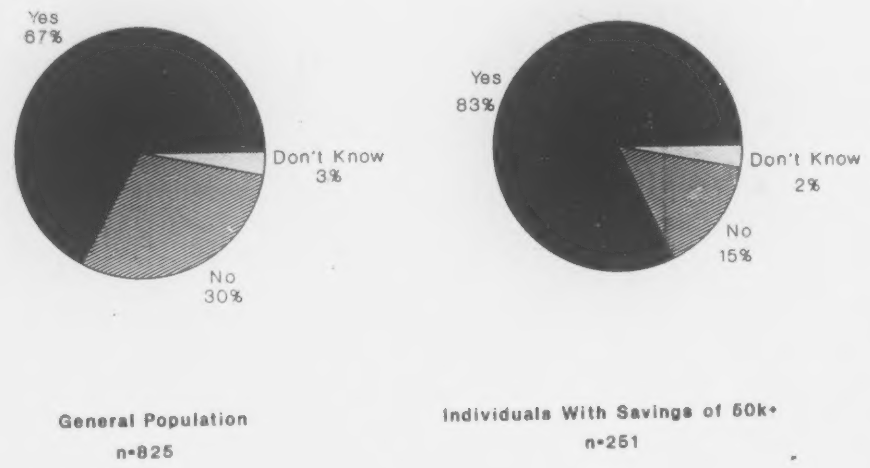
TABLE 7

Whether 10% Deductible Would Affect Savings Behavior

		Region					Bank Size	
	General Population %	Northeast %	Midwest %	South %	West %	Individuals With Savings $50K+ %	Small/ Local %	Large/ Nationwide %
Yes	67	72	65	66	65	83	62	69
No	30	26	29	32	33	15	32	30
Don't know	3	2	6	3	1	2	6	1
(BASE)	(834)	(173)	(236)	(299)	(126)	(251)	(228)	(300)

Source: Question 10

Figure 4
Whether 10% Deductible Would Affect Savings Behavior



General Population
n=825

Individuals With Savings of 50k+
n=251

TABLE 8

Whether Co-Insurance Would Affect Savings Behavior

		Region					Bank Size	
	General Population %	Northeast %	Midwest %	South %	West %	Individuals With Savings $50K+ %	Small/ Local %	Large/ Nationwide %
Yes	45	43	41	45	54	59	39	47
No	50	51	54	50	44	38	54	51
Don't know	4	5	5	5	2	3	8	2
(BASE)	(833)	(172)	(236)	(299)	(126)	(250)	(228)	(300)

Source: Question 11

Figure 5
Whether Co-Insurance Would Affect Savings Behavior

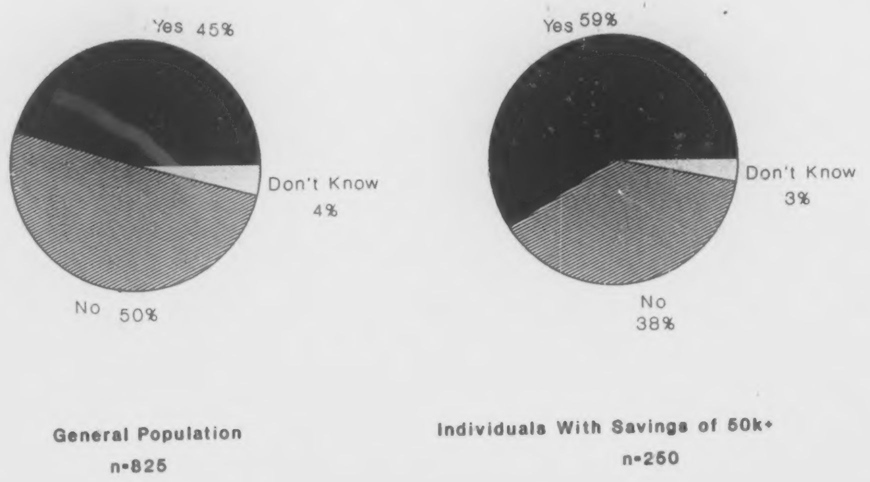


TABLE 8A

How Co-Insurance Would Change How Much or Where One Save[1]

	General Population %	Individuals With Savings $50K+ %
Distribute Savings Across Institutions	46	59
Keep Less Money In Savings Account/Bank	18	18
Analyze the Private Firm/Depends on Private Firm	12	10
Move Money into Money Market Fund or Other Investment	4	3
Other	8	5
Don't know	16	7
(BASE)	(368)	(148)

Source: Question 12

---

[1] Table includes multiple mentions

APPENDIX

QUESTIONNAIRE

INDEPENDENT BANKERS ASSOCIATION OF AMERICA SURVEY

We now have some questions about a topic that has been in the news -- the Federal Government's insurance on bank accounts.

1. Do you have either a savings, checking, money market account, or IRA or certificate of deposit with a bank, savings and loan, or credit union?

Yes	[ ]1	
No	[ ]2	**(SKIP TO NEXT SECTION)**

2. Is your primary financial institution, where you have most of your money, a bank, a savings and loan, or a credit union?

Bank	[ ]1	
Savings and loan	[ ]2	**(GO TO QU.4)**
Credit union	[ ]3	**(GO TO QU.4)**

3. Is your primary financial institution, where you have most of your money, a small local or community owned bank, or a large statewide or nationwide bank?

A small local or community owned bank	[ ]1
A large statewide or nationwide bank	[ ]2
Don't know	[ ]3

4. Do you feel that your savings are safer in a large statewide or nationwide bank, safer in a small local or community owned bank, or equally safe in both places?

	A large statewide or nationwide bank	[ ]1
	A small local or community owned bank	[ ]2
	Equally safe in both places	[ ]3
DO NOT READ	Don't know	[ ]4
	Doesn't matter to me or don't care	[ ]5

5. Do you feel that the Federal deposit insurance makes your money safer at a bank, safer at a savings and loan, or safer at a credit union, or do you think Federal insurance makes your money equally safe at all three institutions?

	Bank	[ ]1
	Savings and loan	[ ]2
	Credit union	[ ]3
	Equally safe at all three	[ ]4
DO NOT READ	Don't know	[ ]5
	Doesn't matter to me or don't care	[ ]6

6. Does the type of Federal insurance covering banks, savings and loans, and credit unions affect your decision as to the type of institution in which to keep your savings?

Yes .... [ ]1
No .... [ ]2
Don't know .... [ ]3

7. The Federal government now fully insures depositors up to $100,000 at each institution. Suppose Federal deposit insurance for each person at each institution were limited to $90,000. Would this affect how much or where you saved?

Yes .... [ ]1
No .... [ ]2 **(GO TO QU.8)**
Don't Know .... [ ]3 **(GO TO QU.8)**

7a. How would this change how much or where you saved? **(DO NOT READ LIST)**

I would keep less money in savings accounts ..... [ ]1

I would move my money to money market funds ... [ ]2

I would distribute my savings across more institutions [ ]3

Other:______________________________

____

GO TO QUESTION 10

8. Suppose Federal deposit insurance for each person at each institution were limited to $75,000. Would this affect how much or where you saved?

Yes .... [ ]1
No .... [ ]2 **(GO TO QU.9)**
Don't Know .... [ ]3 **(GO TO QU.9)**

8a. How would this change how much or where you saved? **(DO NOT READ LIST)**

I would keep less money in savings accounts . . . . . [ ]1

I would move my money to money market funds . . . [ ]2

I would distribute my savings across more institutions [ ]3

Other:____________________________________

____

GO TO QUESTION 10

9. Suppose Federal deposit insurance for each person at each institution were limited to $50,000. Would this affect how much or where you saved?

Yes . . . . [ ]1
No . . . . [ ]2 **(GO TO QU.10)**
Don't Know . . . . [ ]3 **(GO TO QU.10)**

9a. How would this change how much or where you saved? **(DO NOT READ LIST)**

I would keep less money in savings accounts . . . . . [ ]1

I would move my money to money market funds . . . [ ]2

I would distribute my savings across more institutions [ ]3

Other:____________________________________

____

10. Presently, the Federal government fully insures depositors up to $100,000. If depositors were fully insured up to $10,000 if their bank failed, but were required to cover 10 percent of the loss between $10,000 and $100,000, would this change how much or where you saved?

Yes . . . . [ ]1
No . . . . [ ]2
Don't know . . . . [ ]3

11. Again, at present, the Federal government fully insures depositors up to $100,000 at each institution. Suppose the Federal government insured depositors up to $50,000 and private companies insured bank depositors for amounts over $50,000. Would this change how much or where you saved?

Yes .... [ ]1
No .... [ ]2 **(GO TO QU. 13)**
Don't know .... [ ]3 **(GO TO QU. 13)**

12. How would this change how much or where you saved? **(DO NOT READ LIST)**

I would keep less money in savings accounts .... [ ]1

I would move my money to money market funds ..... [ ]2

I would distribute my savings across more institutions . [ ]3

Other: ____

____

13. In all your savings and checking accounts, including CDs, money market accounts and IRAs, approximately how much do you currently have in total? Would you say you have **(READ LIST)**:

Under $10,000 .... [ ]1
$10,000 to under $50,000 .... [ ]2
$50,000 to under $75,000 .... [ ]3
$75,000 to under $100,000 .... [ ]4
Over $100,000 .... [ ]5

APPENDIX E

EDGAR, DUNN
& CONOVER INC.
Management Consultants

February 12, 1989

Mr. O. J. Tomson
President
Independent Banks Association of America
One Thomas Circle N.W., Suite 950
Washington, D.C. 20005-5802

Dear Mr. Tomson:

As requested, I am forwarding a summary of our findings resulting from interviews with the members of the insurance industry. The purpose of this engagement was to assess the degree of interest within the industry for offering private deposit insurance. It should be noted that only one segment of the industry - the financial guaranty segment - is exploring the issues and they have only recently initiated their assessment.

Our findings are attached. Should you have any questions or wish to discuss this preliminary assessment, please give me a call.

Sincerely,

Jonathan H Parker

Jonathan H. Parker

JP:by

Attachment (1)

James M Edgar
Peter T Dunn
Norris S Bernstein
Geoffrey D Griffin
Carole Kay Lynn
R T McNamar
Jonathan H Parker
David A Poe
Peter F Scott
Jeffrey T Webber
Robert M White

847 Sansome Street
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EDGAR DUNN
& CONOVER INC.

INSURANCE INDUSTRY PARTICIPATION IN DEPOSIT INSURANCE

Preliminary Findings

Introduction

Currently, only companies active in the financial private guaranty sector of the industry have expressed interest in evaluating the deposit insurance issue. These companies are in the early stages of assessing whether there is a profitable opportunity, what changes to the regulatory environment must be met to justify private participation, and what products/pricing might be offered. At best, the current level of enthusiasm for offering private deposit insurance is skeptical and cautious.

Sizing The Issues

In preparing for discussions with the insurance industry, we examined the distribution of deposits by size of bank and the distribution of deposits by size of account.

TABLE 1: Assets/Deposits by Size of Bank (3-31-89)

		Amounts in Trillions of Dollars		
Bank Size	Institutions	Total Assets	Total Deposits	Domestic Deposits
> $1 Billion	371	$2.20	$1.60	$1.28
< $1 Billion	13,629	.94	.82	.81
All FDIC Banks	14,000	$3.14	$2.42	$2.09
> $1 Billion	3%	70%	66%	61%
< $1 Billion	97%	30%	34%	39%
All FDIC Banks	100%	100%	100%	100%

Considering the concentration of risk and the historical regulatory practice of protecting all deposits at large banks, two conclusions can be derived from Table 1. First, the impact on the insurance fund of a "failure" of a large bank averages approximately $4.3 billion (total deposits divided by number of institutions) versus an average impact of $60 million arising from a "small" bank failure. Secondly, the small banks are paying FDIC insurance premiums on 99% of their total deposit base while large banks are subject to FDIC premiums on only 80% of their total deposit base. Stated another way, the large banks pay no FDIC premiums on approximately $320 billion of their deposit base despite the fact that all deposits have been protected during regulatory actions. This disparity becomes even more pronounced if non-deposit liabilities were considered.

The regulatory agencies have not collected comprehensive statistics on the distribution of insured deposits by the size of account. The FDIC did report however that as of June 1989 deposit accounts with balances of less than $100,000 represented approximately 64% or $1.37 trillion of insured deposits while accounts with balances greater than $100,000 represented approximately 36% or $762 billion.

Private Insurance - Preliminary Findings

From interviews with the insurance industry, two patterns quickly emerged. Companies that were not active in the financial guaranty sector of the industry had no interest in the issue. It was clear that they viewed the current system as out of control, with inadequate insurance reserves, inadequate regulatory/reporting requirements, and uneven enforcement of the existing regulatory provisions. Four firms had experimented with offering insurance for deposits in excess of $100,000 but had found there to be very little demand.

The "financial guaranty" sector of the industry comprised of approximately nine primary companies with 1988 combined total assets of approximately $4.5 billion is familiar with the issues and is exploring possible roles on a rather tentative basis. Most of these companies were launched in the early 1980's with their primary focus being the insurance of debt offerings - especially muni bonds so the offerer could attract capital more efficiently and possibly at lower coupon rates. The outlook in their primary market - muni bonds - has declined for a variety of reasons and the industry is attuned to seeking new market opportunities.

Members of this industry segment are in the process of exploring whether there is a set of conditions which if met would create an opportunity for some form of private deposit insurance and if so, what types of coverage are appropriate, how underwriting, risk assessment, monitoring and pricing should be accomplished.

The industry's assessment and conclusions will be developed over the next twelve - eighteen months and their current level of enthusiasm should be regarded in my opinion as skeptical, and cautious at best.

Below, I describe some of the primary factors in their preliminary thinking as they launch their assessment. I should note, that this group is very experienced in bank analysis.

Availability of any Private Insurance will be Selective

- Availability will be restricted to those institutions that the insurers deem are credit worthy
- Smaller institutions probably lack the size to represent attractive customers
    - The traditional underwriting process and subsequent monitoring of financial condition is labor intensive
    - One company finds each analyst capable of handling only 20 institutions
    - The industry is uncomfortable with its ability to streamline the underwriting/monitoring process due to what it views as unreliable, incomplete, and untimely financial information
    - Small institutions are considered by some as higher risk due to limited geographic and industry diversification of its loan portfolio
    - Some were concerned about volatility at small banks: the balance sheet impact of defaults on a small number of relatively large loans

Market Discipline

- Private coverage, if extended to any, will be offered only to credit worthy institutions
- Private coverage will be cancelled if the condition of the institution deteriorates below predetermined threshold
- Private carriers will seek pro rata claim on assets to offset any losses incurred:
    - Such "control" is fundamental to insurers right to mitigate its "claims paid"

  - Will regulatory process permit private sector role in disposition of assets
- Regulatory process must mandate uniform insurance requirement
  - If all deposits to be protected; all must be insured
  - Claims paid must be restricted to those insured

"Too Large To Fail" is an Issue

- Encourages imprudent risks, growth, etc.
  - Substitutes size for quality
  - Creates a huge unfunded risk
- Government must address the issue
  - Market value accounting
  - Risk based premiums

Credit Worthiness

- Underwriting is complicated/time consuming since financial reporting does not reflect asset quality
  - Assets not marked to market
  - Mix of loan portfolio requires special analysis
  - Reporting permits management judgement/intervention
  - Access to independent accountants/bank examiner reports is restricted
- Traditional reports are not timely; months elapse between reporting date and release of information
- Undiversified portfolios subject to regional economic downturns (e.g. agriculture, oil)
- Change in condition can occur quickly, how can the insurer monitor

- "The government with its resources has not had notable success"

Product Types

- A variety of possible product types have been mentioned, but the industry is primarily focusing on whether there is a market
- The term most commonly cited was "annual, renewable" the theory being that the insurers right to not renew would provide 1) a lower premium, and 2) a market discipline

Pricing

- Premature for any specifics
- Probable that industry will offer tiered pricing that reflects its assessment of risk at each bank
  - But coverage will not be universally available

Status of Industry Assessment

My understanding is that members of the financial guaranty segment of the insurance industry will contribute to a preliminary position paper that outlines a regulatory environment and a cooperative deposit insurance program where the private sector would be encouraged to play a role. I believe this will be complete by January 30, 1990.

Summary

Based upon our interviews to date, it is my judgement that private insurers will not assume any portion of the risks inherent in the deposit insurance/regulatory system as it currently operates.

APPENDIX F

CAPITAL DEFINITIONS

Primary capital: common stock, perpetual preferred stock, surplus, undivided profits, contingency and other capital reserves, mandatory convertible instruments, allowance for loan and lease losses, minority interest in equity accounts of consolidated subsidiaries, perpetual debt instruments (for bank holding companies only)
Required ratio: 5.5%

Secondary capital: limited life preferred stock (including related surplus), bank subordinated notes and debentures, unsecured long-term debt of the parent holding company and its nonbank subsidiaries
Required ratio: Primary + Secondary = 6%

Tier 1 - Core Capital: Common stockholders equity, qualifying noncumulative perpetual preferred stock, qualifying perpetual preferred stock, minority interest in the equity accounts of consolidated subsidiaries
Required ratio: 4% of risk-weighted assets

Tier 2 - Supplementary Capital: allowance for loan and lease losses, perpetual preferred stock, hybrid capital instruments and mandatory convertible debt securities, term subordinated debt and intermediate term preferred stock and related surplus
Required ratio: 4% of risk-weighted assets for a total of 8% risk-adjusted capital. Tier 2 shall not to exceed 100% of Tier 1 and loan loss reserve limited to 1.25 % of risk-adjusted assets.

Deductions from capital: goodwill and nonqualifying intangibles, reciprocal holdings of capital instruments of banking organizations, investments on unconsolidated banking and finance subsidiaries, investments in other designated subsidiaries or associated companies on a case-by case basis

Core Capital: As defined by FIRREA, this uses OCC definition of core but permits the inclusion of goodwill.
Required ratio: 3% for thrifts, must include 1.5% tangible capital.

Tangible capital: Considered the equity components of core capital and excludes intangibles except purchased mortgage servicing rights.
Required ratio: 1.5% for thrifts

Equity Capital: Primary capital less allowance for loan losses, all debt and investments. Required ratio: unknown

Hard capital: synonym for core capital (thrifts)

Leverage ratio: Is a ratio to be used in tandem with risk-based capital not as a stand-alone figure.
Required Ratio: 3-6%--regulators not uniform

APPENDIX G

Federal Deposit Insurance System Study

AGENCY: Department of the Treasury.

ACTION: Request for comments.

SUMMARY: The Secretary of the Treasury (Secretary) is conducting a study of the federal deposit insurance system, as directed by section 1001 of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA), Public Law No. 101–73, 103 Stat. 183 (1989). Pursuant to FIRREA, the Secretary intends to complete the study within 18 months from the date of enactment of FIRREA (August 9, 1989) and to submit to the United States Congress a final report containing a detailed statement of findings, conclusions, and recommendations, if any, for administrative and/or legislative action determined by the Secretary to be appropriate.

In recognition and support of the legislation's requirement of consultation with the private sector and to gather the information needed for the study, this notice invites all interested parties to present their views on the topics discussed below and on any other issues relating to the study that they may wish to bring to the attention of the Secretary. The Secretary strongly encourages all interested parties to submit comments for the record.

DATE: Comments must be received by March 9, 1990.

ADDRESS: Interested parties are requested to submit ten (10) copies of written data, views, or arguments regarding any or all of the topics discussed below or otherwise relevant to the study. Copies will be distributed to the numerous participating agencies and will be used to create a public file to be maintained at the Department of the Treasury.

Such copies may be sent to:

Federal Deposit Insurance System
Study, Department of the Treasury,
Room 3025, 1500 Pennsylvania
Avenue, NW., Washington, DC 20220.

FOR FURTHER INFORMATION: For further information, please contact: Gordon Eastburn, Director of the Office of Financial Institutions Policy, at 202–566–5337; Brian S. Tishuk, Financial Analyst, at 202-566-4212; or Elizabeth Shiry, Study Coordinator, at 202-566-2505.

SUPPLEMENTARY INFORMATION: On August 9, 1989, President George Bush signed into law the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA), Public Law No. 101-73, 103 Stat. 183 (1989). Section 1001 of FIRREA directed the Secretary of the Treasury to conduct a study of the federal deposit insurance system in consultation with the Comptroller of the Currency, the Chairman of the Board of Governors of the Federal Reserve System, the Director of the Office of Thrift Supervision, the Chairman of the Federal Deposit Insurance Corporation, the Chairman of the National Credit Union Administration, the Director of the Office of Management and Budget, and individuals from the private sector.

Need for Federal Deposit Insurance Study

The federal deposit insurance system was created by the Banking Act of 1933. During the past 56 years, the financial services marketplace has changed dramatically, and individuals and organizations in both the public and private sector have questioned how well the deposit insurance system is working—particularly in light of the failure of the thrift insurance fund—and whether the current system needs major reforms.

Through the deposit insurance system study, the Secretary will, among other things, examine the strengths and weaknesses of the deposit insurance system, consider proposed methods of reducing the risk of loss to the federal deposit insurance funds, and analyze the feasibility and desirability of alternatives to the system itself.

Suggested Format of Comments

Section 1001 of FIRREA lists the topics relating to the deposit insurance system Congress directed the Secretary to study. These topics and other related issues are presented below and have been grouped under broad headings. In preparing comments, please discuss the issues pertaining to deposit insurance, analyze the strengths and weaknesses of the existing programs, and propose any alternative policies or programs.

Federal Deposit Insurance System Issues

Purpose and History of Federal Deposit Insurance

Interested parties are requested to provide the Secretary with their views on the goals of the federal deposit insurance system and the success of the system in meeting these goals. The traditional goals of federal deposit insurance include: Stabilizing the financial system and protecting depositors. Commentators may address these and other goals in a discussion of the purpose and history of the current federal deposit insurance system.

In addition, commentators may address the concerns that the system has engendered, such as the subsidization of certain bank activities, the "too big to fail" problem, and the system's incentive for depository institution operators to take excessive risks because the federal deposit insurance funds will bear most of the ultimate losses.

Interested parties are also requested to review the deposit insurance systems of foreign countries to compare and contrast those systems with our current one.

Monitoring and Measuring Risk

Auditing and On-Site Examination. The Secretary seeks comments on whether a closer relationship between depository institution auditors and regulators would benefit the deposit insurance system.

Interested parties are asked specifically to address the following issues: (1) Requiring the independent auditors and accountants of a federally insured depository institution to report the results of any audit of the institution to the appropriate regulator(s); (2) requiring the appropriate regulator(s) to share reports on a depository institution with the institution's independent auditors and accountants; and (3) requiring the independent auditors and accountants of federally insured depository institutions to participate in conferences between the regulator and the depository institution.

Comments are also requested on the feasibility of adopting regulations that are the same as, or similar to, the audit provisions of England's Banking Act, enacted on May 15, 1987, which affects the Bank of England's relationship with auditors and reporting accountants (including sections 8, 39, 41, 45, 46, 47, 82, 83, 85, and 94 of such Act). Comments may explore whether such a law would be necessary if some or all of the three other audit proposals were adopted, or whether the Bank of England provisions show more merit than the other three proposals.

Market Value Accounting. The Secretary seeks comments on the feasibility of implementing market value accounting. Commentators are asked to discuss how such an accounting system could be developed and the impact it would have on depository institutions. Specifically, interested parties could discuss the implications of such an accounting system on capital requirements, especially for depository institutions with long-term assets. Making long-term assets to market on a daily basis may lead to large swings in the assets' value and commensurate swings in the need for capital. Comments may also address the feasibility of exempting long-term assets from any market value accounting proposal.

Risk-Management Techniques. Interested parties are requested to consider the feasibility of developing and administering through the appropriate federal depository institution regulators an examination of the principles and techniques of risk management and the application of such principles and techniques to the management of insured institutions.

Incentives to Control Risk

Scope of Deposit Insurance Coverage. Comments are requested on the scope of deposit insurance coverage and its impact on the liability of the insurance fund, that is, whether to change the level of deposit insurance and/or the types of deposits and accounts eligible for coverage. In addition, interested parties may wish to discuss the implications on, and incentives for, market discipline of providing *de facto* insurance of all accounts in certain circumstances.

In particular, interested parties are requested to discuss: (1) Limiting each depositor to one insured account per institution; (2) reducing the amount insured, or providing for a graduated decrease in the insured percentage of the amount deposited as the amount deposited increases; (3) combining federal with private insurance in order to bring the market discipline of private insurance to bear on the management of the depository institution; and (4) ensuring by law or regulation that when an insured depository institution is closed, the appropriate federal insurance fund will honor only its explicit liabilities and will never make good any losses on deposits not explicitly covered by federal deposit insurance.

Risk-Based Premiums. Comments are also requested on the feasibility of charging risk-based premiums for federal deposit insurance. Commentators should address how risk would be measured and the criteria by which premiums would differ. In particular, comments should discuss how asset quality and interest rate risk would be measured; how management quality would be gauged; how an institution's profitability and capital level would figure in the risk calculus; and what relationship risk-based premiums would have with risk-based capital requirements. Comments should also address how the cutoff points of the differing levels of premiums would be determined and how large the differences among the premiums would have to be to induce the desired behavior.

Capital Adequacy. Interested parties are requested to consider capital adequacy in a discussion of protecting against a depository institution's level of risk to the insurance fund.

Optimal Fund Reserve Level. Commentators may also address the relationship of the current system's assessment structure to the optimal level of insurance fund reserves.

Closure or Recapitalization of Insolvent, or Nearly Insolvent, Institutions

The Secretary seeks comments on defining the policies to be followed when determining whether to recapitalize or to close federally insured depository institutions that are, or are about to become, insolvent. Commentators should discuss how the appropriate regulator would determine whether to assist or to arrange to close a federally insured depository institution before it becomes insolvent. When certain criteria are defined, should the early intervention be mandatory or discretionary?

The Office of Thrift Supervision plans to issue soon a notice of proposed rulemaking for determining whether to assist or to declare an institution to be in an unsafe and unsound condition when its capital level falls below a certain threshold. The Office of the Comptroller of the Currency is currently finalizing its own regulation, which would require a similar determination to be made when an institution's equity has been depleted. The Federal Deposit Insurance Corporation has the authority to suspend the federal deposit insurance of an insured institution if that institution has insufficient capital or if it is otherwise being operated in an unsafe and unsound manner.

Commentators may wish to discuss these methods of addressing the issue in their analysis and to address the feasibility of applying any of them to all depository institutions. Interested parties may also address what the appropriate threshold (of capital, equity, or some other measure) ought to be and whether only a single regulator should be authorized to make such a determination for all depository institutions. Some may also wish to discuss the legal or economic ramifications of the proposal, including any incentives it may have for depository institution managers as they approach the applicable threshold.

Alternative Federal Deposit Insurance Systems

Comments are requested on the feasibility of alternative deposit insurance system structures, including supplementing or replacing the current system structure with private or state insurance. Interested parties may also discuss the feasibility of structures that do not include the insurance of deposits.

Modifying the Insurance Base

Interested parties are also requested to discuss whether the insurance base should be modified. Specifically, comments are requested on: (1) Adding collateralized borrowings to the insurance base; (2) limiting brokered deposits; and (3) assessing premiums on foreign deposits. Comments are also requested on the desirability of retaining multiple insured accounts.

Comments should address the feasibility of each of these proposals and the effect each would have on the deposit insurance system.

State and Federal Bankruptcy Exemptions

Comments are requested on the feasibility of three proposed methods of addressing the disparate treatment of depository institutions, as the holders of loan assets, under state and federal bankruptcy laws. Some state bankruptcy laws provide more generous exemptions than does the federal law, which affects not only the bankrupt individual, but the ability of the depository institution holding the loan to collect on it.

The three methods of addressing this issue are: (1) Establishing uniform exemptions; (2) placing limits on exemptions when necessary to repay obligations owed to federally insured depository institutions; and (3) requiring a borrower from a federally insured depository institution to post a personal or corporate bond when obtaining a mortgage on real property.

Credit Unions

Capital Adequacy. The Secretary seeks comments on whether insured credit union capital levels are adequate and whether the Credit Union Share Insurance Fund is adequately capitalized. Currently, credit union premium payments are carried as assets by both the Share Insurance Fund and by the paying credit unions. Comments are requested on how this arrangement is likely to work in a crisis affecting a number of credit unions, or the credit union industry as a whole.

Separating the Regulation Function From the Insurance Function. The Secretary also seeks comments on whether the regulatory and insurance functions, currently performed by a single agency, the National Credit Union Administration, should be separated within the credit union regulatory structure.

Federal Home Loan Bank System Housing Subsidies

The Secretary seeks comments on the efficiency of providing credit subsidies for housing through the Federal Home Loan Bank System.

Interrelationships of Regulation, Federal Deposit Insurance, and Financial Activities

This section will draw on the preceding sections to discuss the current interrelationships among deposit insurance, regulation, and financial activities; how that interrelationship has evolved; and the appropriate interrelationship for the future. The Secretary encourages interested parties to submit comments on this issue.

Dated: December 1, 1989.

David W. Mullins, Jr.,

Assistant Secretary (Domestic Finance), Department of the Treasury.

[FR Doc. 89–28436 Filed 12–5–89; 8:45 am]

BILLING CODE 4810-25-M

The **Chairman**. Thank you. We appreciate your statement and the thought it represents.

Now, Mr. David Silver, who is president of the Investment Company Institute.

STATEMENT OF DAVID SILVER, PRESIDENT, INVESTMENT COMPANY INSTITUTE

Mr. **Silver**. Thank you, Mr. Chairman.

I am David Silver, president of the Investment Company Institute. We appreciate the opportunity to testify at these hearings. I am pleased to announce today that our board has endorsed an affirmative, balanced legislative proposal to restructure the financial services industry. Our initiative attempts to resolve a central dilemma which must be surmounted as the Congress works to shape the post-Glass-Steagall financial world. The dilemma is this: How to grant increased powers to banking entities in a commercially viable form while providing for the safety of the Federal deposit insurance funds, the protection of investors and a fair field of competition? Even writing on a blank slate, this would be a formidable task.

Most previous legislative proposals have attempted to resolve this dilemma by requiring that banks conduct their securities activities through affiliates separated from the banks by legal firewalls. As history demonstrates, however, firewalls often fail when they are most needed—in times of crisis. In order to provide for adequate safeguards, then, it is necessary to strengthen those firewalls so that they are as sturdy as possible.

However, major banks have stated that under a regime of strong firewalls they will be unable to take advantage of the "synergies" that make increased powers commercially attractive. Indeed, due to the continuing commercial pressures to achieve synergies, over time, both firewalls and the will of the regulators to enforce their observance may well be eroded.

One possible response—the one favored by major banks—is to abandon the separate affiliate-firewall approach and permit the establishment of "universal banks," which could engage in both traditional banking and securities activities. In his testimony before this committee on April 3, Thomas Labrecque, on behalf of five banking associations, backed this approach, stating that all financial institutions should be "free to decide which products and services to offer." It is true that this would allow for synergies. However, it also opens the door to abuses, such as public confusion arising from the sale of the uninsured deposit-like securities by banks.

Major banks have also argued that universal banking is necessary in order to allow them to compete internationally, especially after 1992. It is true that several Western European nations permit universal banking.

However, there is an important difference, not previously been focused on, between banking in the United States and banking in most Western European countries that have adopted the universal banking system.

In Western Europe, deposit insurance is, for the most part, private and voluntary. And in those "universal banking" countries that have government deposit insurance, the level of insurance is far less than the equivalent of $100,000, which results in substantially less risk to the public purse.

An alternative would be to adopt completely the Western European model and to eliminate, or substantially reduce, the scope of deposit insurance. Yet this runs the risk of upsetting the legitimate expectations of depositors. People of modest means should not have to read financial statements to find a safe place to save.

We also question the premise underlying the call for universal banking—that it is necessary in order for U.S. banks to compete internationally. Much has been made recently of the fact that in terms of assets there are no American banks in the worldwide "Top Ten." But, as was pointed out on April 3 by you, Mr. Chairman, American banks are generally more profitable than their larger foreign counterparts. In fact, American banks are smaller for a whole variety of reasons, including the remaining restrictions on interstate banking. We do have a record 13,000 banks and S&L's, probably as many as the rest of the world combined. Certainly, no one argues that the deposit insurance system should be subjected to unneeded risks simply in order to allow Citicorp or Chase Manhattan to make a Top Ten list.

For these reasons, the Institute believes that a universal banking scheme is not the proper approach to restructuring.

Another solution to the dilemma would be to reduce risks by limiting the scope of new powers granted to bank affiliates. For example, previous proposals have tried to draw distinctions between underwriting corporate debt and underwriting corporate equity.

We feel that this approach, too, fall short. It would remove one set of barriers while erecting a second set. The likely result is that we would simply have to engage in another restructuring effort in the not-too-distant future. It would also lead to unfair competition, since banks would be permitted to engage in certain securities activities, while full-service securities firms would continue to be barred from banking.

The Institute believes that a third approach is necessary. This approach would combine a broad view of permissible activities with strict standards for the use of federally insured deposits.

In order to ensure the full benefits of synergies and vigorous, fair competition, banks and securities firms should be allowed to offer all types of financial services. In order to provide for a two-way street, concurrent with the repeal of the Glass-Steagall Act, section 4 of the Bank Holding Company Act should be amended so that it would no longer serve as a bar to the Nation's major securities firms becoming affiliated with commercial banks.

Along with increased powers, it is vital that any proposal to restructure the financial services industry provide for the protection of the Federal Deposit Insurance System.

In order to reduce risks to the deposit insurance funds and to prevent banks from unfairly subsidizing their securities affiliates and other nonbanking activities, it is necessary, we believe, to enhance previously proposed firewalls with the strongest safeguard that has been put forth—the "narrow or safe bank." Under this proposal, banks affiliated with securities firms would be entitled to Federal deposit insurance only if their portfolios were limited to safe, highly liquid instruments. When combined with necessary firewalls, the narrow bank would provide a comprehensive approach to deposit insurance reform.

The Institute also believes that, at least for a transition period, it is necessary to prohibit bank affiliated financial products from being sold under the name of the bank. Otherwise, there will be a substantial risk of confusion on the part of investors. For example, mutual funds sponsored by bank affiliates should be prohibited from having the same name as that of the bank at least for a 3 or 5-year period or even longer given the rule-making authority of the appropriate agencies.

There is also a need for firewalls designed to protect mutual funds and their shareholders from conflicts arising from an affiliated bank's role as a commercial lender. Currently, securities firms that sponsor mutual funds are subject to similar firewalls.

Finally, any changes in the legislation and regulations governing financial services must be accompanied by corresponding changes to the regulatory structure. It really does not sit well, Mr. Chairman, for any of us to urge that the business lines of heretofore separate financial institutions be combined while we continue to insist that the regulatory agencies adhere to narrow product line origins. It seems to me that if there is an argument that product lines are so blurred that they must be combined, something must be done on the regulatory level.

Functional regulation itself, under the present regulatory scheme therefore is not enough and the question naturally arises whether there is a need for some sort of "super-regulator."

I would not go so far as to create a super-regulator that would govern the full range of activities which these financial institutions would be permitted to have in the future. If you do so, I think you might end up with something like the NRA of the 1930's, which would be inconsistent with our traditions. But nevertheless, there is a need for the establishment of a body that would serve a critical function, limited as it may be, to oversee and coordinate financial regulation. One possible model for this would be the Working Group on Financial Markets. Another is the proposed Financial Services Commission, the creation of which is part of legislation introduced by Senators Wirth and Graham.

The Institute believes that each aspect of the reform program I have discussed here today is important. Ad hoc administrative dismantling of Glass-Steagall, such as the current attempt by the Comptroller to convert bank common trust funds into unregulated mutual funds, is fraught with the potential for abuse. It is critical that these matters be addressed both in a comprehensive manner and in the proper forum, Congress.

In conclusion, turbulence in the securities markets, the S&L crisis, the LDC debt load assumed by banks, and the exposure of fraud in our financial institutions and markets leads me to believe that the American public will be more interested in the outcome of this legislative effort than we sitting here may believe today. It behooves us all to work toward an outcome which will preserve and enhance the credibility of our financial system.

We appreciate the opportunity of testifying here today and look forward to working with you to resolve this complicated subject. Thank you.

[The complete prepared statement of David Silver follows:]

SUMMARY OF PRINCIPAL POINTS
STATEMENT OF DAVID SILVER
PRESIDENT
INVESTMENT COMPANY INSTITUTE

BEFORE THE
COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS
UNITED STATES SENATE
ON LEGISLATION TO MODERNIZE
THE REGULATION OF FINANCIAL SERVICES

APRIL 24, 1990

I. INTRODUCTION

The Institute supports legislation to restructure the financial services industry. It is necessary that a comprehensive reform of financial services--encompassing deposit insurance, consumer protection and competitive fairness--be undertaken in the only proper forum for these issues, Congress.

II. THE INSTITUTE'S REFORM PROGRAM

A. Summary

B. Competitive Fairness

Legislation must provide for competitive fairness, or a "two-way street", that allows banks and securities firms to offer all types of financial services. A one-sided approach to deregulation that simply grants banks various securities powers will substantially reduce the benefits of financial services reform. In order to provide for a two-way street, it is necessary that Section 4 of the Bank Holding Company Act be amended. Several recent legislative proposals have recognized the need for a two-way approach and the Institute believes it is the proper one.

C. Protection of the Federal Deposit Insurance System

One of the most important goals of any proposal to restructure the financial services industry must be the protection of the federal deposit insurance system. As the ongoing crisis in the thrift industry demonstrates, the combination of increased powers and a federal safety net is potentially ruinous.

In order to protect against risks to the insurance fund and the use by banks of lower-cost insured deposits to subsidize unfairly securities and other activities, it is necessary to insulate the insured depositary from the securities firm. The simplest and most comprehensive means of achieving this is through a combination of firewalls and a "narrow bank", under which a bank affiliated with a securities firm would be entitled to federal deposit insurance only if its portfolio were limited to safe, liquid securities.

In contrast, many large banks have endorsed the concept of a "universal bank". However, most nations that permit universal banking do not provide for government deposit insurance.

D. Regulatory Structure

The Institute has long supported the concept of functional regulation, under which similar products are subject to the same regulatory controls regardless of the type of financial institution offering the product. Under current law, banks have not been made subject to the same regulatory controls as other providers of financial services. We also believe that functional regulation casts doubt upon the universal banking notion because the same entity may be subject to different regulatory controls.

The Institute believes that the arguments for an oversight regulatory body are not without merit. However, such an entity should not have unlimited powers. Instead, a body with the more limited function of overseeing and coordinating financial regulation should be established.

E. The Need for Special Investment Company Firewalls

The Investment Company Act currently contains numerous provisions to protect mutual funds from possible conflicts on the part of securities firms that sponsor the funds. If banks are granted the ability to sponsor and underwrite mutual funds, it is necessary to enact statutory firewalls to protect affiliated funds and their shareholders from similar conflicts of interest and other possible abuses.

For example, at least for a transition period following the passage of restructuring legislation, mutual funds sponsored by bank affiliates should be prohibited from having a name that is the same as, or similar to, that of the bank in order to guard against investor confusion. In addition, firewalls (similar to those governing securities firms) are needed to address conflicts arising from an affiliated bank's role as commercial lender.

III. A PROPER APPROACH TO REFORM OF THE FINANCIAL SERVICES INDUSTRY

It is important that these matters be addressed in a comprehensive manner and in the proper forum, namely Congress. In contrast, the Comptroller of the Currency recently has proposed to eliminate historic safeguards on the operation of bank common trust funds and to convert these administrative devices into publicly offered mutual funds, without necessary protections for the consumer, the FDIC or the banking system.

IV. CONCLUSION

I am David Silver, president of the Investment Company Institute. The Institute is the national association of the American investment company industry. Its membership includes 3,004 open-end investment companies ("mutual funds"), 192 closed-end investment companies and 13 sponsors of unit investment trusts. Its investment company members have assets of approximately $949 billion, accounting for approximately 90% of total industry assets, and have over 30 million shareholders.

I. INTRODUCTION

The Institute appreciates the opportunity to testify before you on the need for comprehensive legislation to restructure the financial services industry. Investment companies represent a highly competitive segment of the financial services industry and the Institute has long taken an active interest in legislative initiatives in this area.

The Institute endorses the need for legislation to restructure the financial services industry. This January, the Institute's Board of Governors adopted a resolution favoring a new legislative approach in this area.

As you know, in the past, the Institute has not endorsed efforts to repeal or amend the Glass-Steagall Act by granting new securities powers to banks. Frankly, we remain somewhat skeptical over the claims that the protections of the Glass-Steagall Act have not been beneficial to financial institutions or the public.

Nevertheless, the Institute today is endorsing an affirmative legislative proposal. There are two reasons for this.

The first is a recognition that new technologies and innovations have increasingly blurred the traditional distinctions between the businesses of banking and securities. Not only does this lead to the conclusion that both banks and securities firms should, with proper safeguards, be allowed to directly compete with each other in all aspects of the financial services industry, it also requires that our regulatory structure be realigned in order to provide for effective functional regulation.

Second is the fact that certain regulators are enacting fundamental changes in what is both a one-sided and haphazard manner. It is therefore necessary that comprehensive reform--encompassing deposit insurance, consumer protection and competitive fairness--be undertaken in the only proper forum for these issues, Congress. Otherwise we run the risk of a chaotic process of ad hoc deregulation, which could lead to a reprising the thrift crisis.

One example of this is the Comptroller of the Currency's recent proposal to authorize the mass-merchandizing of bank common trust funds to millions of small investors. If adopted, this proposal would transform heretofore administrative devices into mass-marketed mutual funds, without any of the protections for the consumer, the FDIC or the banking system contemplated by the legislative restructuring proposals.

With the foregoing in mind, I would now like to turn to the Institute's proposal for financial services reform.

II. THE INSTITUTE'S REFORM PROGRAM

A. Summary

Our proposal attempts to resolve the central dilemma faced by Congress as it works to construct a post-Glass-Steagall structure. The dilemma is this: How do we accomplish what the granting of increased powers is meant to achieve while at the same time providing for the safety and soundness of federal deposit insurance, the protection of investors and a fair field of competition?

Most previous legislative proposals have attempted to resolve this dilemma by requiring that banks conduct their securities activities through separate affiliates and by imposing firewalls between the bank and its securities affiliate. As history has shown us, however, firewalls often fail when they are most needed--in times of crisis. In order to provide for adequate safeguards, then, it is necessary to strengthen those firewalls so that they are as sturdy as possible.

However, if this approach is taken, many of the perceived benefits of product deregulation may be lost. Major banks have stated that under a regime of strong firewalls they will be unable to take advantage of the "synergies" that make increased powers attractive in the first place.

Indeed, due to the commercial pressures to achieve synergies (for example by identifying the bank with its affiliated financial products and services), both firewalls and the will of regulators to enforce their observance may be undermined.

One possible response to this--the one favored by major banks--is to abandon completely the separate affiliate-firewall approach and permit the establishment of "universal banks", which could engage in both traditional banking and securities activities. In his testimony before this committee on April 3, Thomas Labrecque, on behalf of five banking associations, stated that there must be "sufficient flexibility" to allow all financial institutions to be "free to decide which products and services to offer".

It is true that this would allow for synergies. However it also opens the door to abuses involving the sale of uninsured securities by banks such as in the case of Lincoln Savings & Loan and earlier in the sale of the so-called "yellow certificates" by Golden Pacific National Bank.

Indeed, some major banks seem perfectly willing to use the safety of the bank--which, of course, is dependent on the federal deposit insurance system--to sell risky securities to consumers. For example, in response to a deregulatory ruling by the Comptroller of the Currency that allowed Chase Manhattan Bank to sponsor and sell commodities funds, a Chase spokesman was quoted as saying, "putting the name of a big commercial bank behind these funds will be a big lure to investors".*/

In calling for universal banking, major banks also have overlooked the fact that most of the countries that allow universal banking do not provide for universal, government deposit insurance.

For these reasons, the Institute believes that a universal banking scheme is not the proper approach to restructuring.

Another solution would be to attempt to reduce risks by limiting the scope of new powers granted to bank affiliates. In this regard, previous proposals have tried to draw distinctions between, for instance, underwriting corporate debt and underwriting corporate equity.

The Institute feels that this approach, too, falls short. It would seek to remove one set of barriers while erecting a second set. The result is likely to be that we would simply have to engage in another restructuring effort in the not-too-distant future. It would also lead to unfair competition, since the result would be that while banks would be permitted to engage in certain securities activities, full-service securities firms would continue to be barred from banking.

The Institute believes that a third approach is necessary. This approach would combine a broad view of permissible activities with strict standards for the use of federally insured deposits.

In order to ensure the full benefits of synergies and vigorous, fair competition, banks and securities firms should be allowed broad powers to offer all types of financial services.

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*/ "Chase Ruling Expands Turf in Securities", American Banker, March 19, 1990.

This requires that, concurrent with the repeal of the Glass-Steagall Act, Section 4 of the Bank Holding Company Act be amended. At the present time, Section 4 serves as a bar to the nation's major securities firms from becoming affiliated with a commercial bank.

At the same time, in order to reduce risks to the safety and soundness of the banking system and the insurance fund, and to prevent banks from unfairly subsidizing their securities affiliates and other nonbanking activities, it is necessary to enhance previously proposed firewalls with what we believe is the strongest safeguard that has been put forth--the "narrow bank". Under this proposal, banks affiliated with securities firms would be entitled to federal deposit insurance only if their portfolios were limited to safe, highly liquid instruments.

The Institute also believes that, at least for a transition period, it is necessary to prohibit bank affiliated financial products from being sold under the name of the bank. Otherwise, there will be a substantial risk of confusion on the part of investors. For example, mutual funds sponsored by bank affiliates should be prohibited from having the same name as that of the bank for at least a three to five year period.

The Institute's proposal rests on the same conceptual footing as that of the Securities Industry Association. We share the same goals of allowing the combination of commercial banking with securities activities, while insulating federally insured depositary institutions. However, our proposal builds upon theirs in two important respects.

First, it would permit an affiliated group of financial services companies to engage in a broader array of activities in a more flexible manner. In this regard, I believe it may come closer to meeting the goals of both the major banks and the securities industry.

Second, it would provide stronger safeguards by narrowing the activities in which a federally insured bank could engage. While the SIA proposal attempts to accomplish the same ends through reliance on firewalls, we believe that our approach, using both firewalls and the narrow bank, is more comprehensive and may well prove easier to regulate and monitor.

The Institute also notes that allowing commercial bank affiliates to sponsor and underwrite mutual funds raises special investor protection issues. Consequently, any legislative reform package must contain a special set of firewalls designed to protect the fund and its shareholders from the unique conflicts of interest arising from commercial bank mutual fund activities. This suggestion is not unprecedented; current law contains similar firewalls for securities firms that sponsor mutual funds.

I would like to discuss in more detail the four major aspects of our proposal--a full two-way street, a "narrow bank", the regulatory structure needed for a restructured financial services industry, and a special set of mutual fund firewalls.

B. Competitive Fairness

The first major aspect of the Institute's proposal is the need for competitive fairness or, in other words, a "two-way street". Several prior legislative proposals would have granted banks various securities powers, but continued to prohibit securities firms from engaging in the banking business. The Institute can see no justification for such an approach, which would result in an imbalanced competitive situation. To the extent that product deregulation is meant to benefit consumers (through increased competition) or enhance international competitiveness, a one-sided approach to deregulation will substantially reduce those benefits.

In order to provide for a two-way street, it is necessary that Section 4 of the Bank Holding Company Act be amended. Currently, Section 4 prohibits a bank holding company and its subsidiaries from engaging in non-banking activities that are not deemed by the Federal Reserve Board to be "closely related" to banking. Most of the nation's large securities firms are affiliated with insurance, real estate or commercial firms engaged in activities that cannot satisfy this standard. As a result, unless restructuring proposals include amendments to Section 4 of the Bank Holding Company Act, many of the nation's largest securities firms would continue to be precluded from the banking business, while all banks would be free to engage in major aspects of the securities business.

Some recent legislative proposals have recognized the need for a two-way approach and included the repeal of restrictions contained in the Bank Holding Company Act, as well as in the Glass-Steagall Act. The legislation introduced by Senators D'Amato, Cranston and Garn and by Congressman Barnard follows this approach, and the Institute believes it is the proper one.*/

In order to provide for full two-way competition, it is also necessary that reform legislation include removal of the geographic restrictions on banking contained in the McFadden Act and the Douglas Amendment. Under the current restrictions, large banks have been able to establish nationwide correspondent banking systems through which they can distribute products and services. Thus, if Glass-Steagall is amended to permit banks to engage in securities activities, the larger banks will be able to distribute securities nationally through a system of local banks. In contrast, the branch offices of securities firms will continue to be barred from the business of banking. Full and fair competition, then, requires removal of these geographic restrictions.

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*/ S.530, the "Depository Institution Affiliation Act"; H.R. 1992, the "Depository Institution Affiliation Act".

C. Protection of the Federal Deposit Insurance System

One of the most important goals of any proposal to restructure the financial services industry must be the protection of the federal deposit insurance system. As the ongoing crisis in the thrift industry demonstrates, the combination of increased powers and a federal safety net is potentially ruinous.

The dangers are two-fold. First, insured depository institutions and their affiliates may be encouraged to take excessive risks since any loss will ultimately be the responsibility of the insurance fund, or the taxpayer. This is often referred to as the "moral hazard" problem and it arises solely from the combination of increased powers with a federal safety net. In contrast, one can look at the recent failure of Drexel Burnham Lambert, one of the nation's largest securities firms. That occurred without costs to the taxpayer and without serious disruptions in the marketplace.

If banks are to enter the same businesses as Drexel, we must be certain that future losses will not fall on the American taxpayer. This requires separating the deposit-taking activity from securities activities undertaken by affiliated firms.

The second problem is that banks may be able to finance the securities activities of their affiliates through the use of lower cost funds, due to the presence of federal deposit insurance. Thus, for reasons of competitive fairness as well, it is necessary to insulate the insured depository from the securities firm.

Many previous legislative proposals have sought to address these problems through reliance on firewalls. However, firewalls are not the complete answer. History has shown that, while firewalls may work well in normal, sound times, they tend to collapse just when they are needed most--in times of crisis. For example in the aftermath of the October 1987 market break, Continental Illinois Bank lent over $90 million to its options subsidiary, which had suffered gigantic losses, in direct violation of an existing firewall. The Comptroller of the Currency did institute enforcement proceedings, but only after the collapse of the firewall.

In addition, history indicates that bank regulators will encourage banks to rescue their affiliates in times of crisis. A

1987 FDIC report stated that the Federal Reserve Board supported efforts by banks to bail out their failing REITs.[*/]

In light of these shortcomings, it is necessary that federal deposit insurance be reformed before, or at least simultaneously with, the granting of increased powers to banks or bank affiliates.

The Institute believes that the simplest and most comprehensive proposal is the "narrow bank", developed by Robert E. Litan of the Brookings Institute. The narrow bank concept was included in legislation introduced last year by Senator Dodd.[**/] Under this proposal, a depository institution affiliated with a firm that could engage in securities activities would be entitled to federal deposit insurance only if it limited its portfolio to safe, liquid securities.

If the narrow bank proposal were made part of financial services reform legislation, the two problems I mentioned would disappear. Bank affiliates would not have an incentive to engage in risky activities due to the moral hazard problem. And securities firms affiliated with banks would not have an unfair competitive advantage due to an ability to finance their activities with lower cost funds. When combined with necessary firewalls, the narrow bank approach would provide a comprehensive approach to deposit insurance reform.

Like the proposal of the Securities Industry Association, the narrow bank proposal seeks to insulate deposit insurance from securities activities. In contrast, the major banking associations have called for measures that would only heighten the risks to deposit insurance and exacerbate competitive imbalances.

Specifically, many in the banking industry have begun to call for legislation that would allow "universal banking", similar to the system in several European countries. The claim is that, unless U.S. banks are converted into universal banks, they will be unable to compete internationally, especially after 1992.

This Committee should be very clear on what this proposal for "universal banking" entails. It means that securities activities would be carried out not in a separate affiliate, regulated by the SEC and subject to regulatory firewalls but, instead, in the bank itself.

Before any such program is adopted, or even seriously considered, several questions must be answered:

[*/] FDIC, Mandate for Change: Restructuring the Banking Industry (1987) at 69-70.

[**/] S.308, the "Financial Modernization and Safe Bank Act", Congressional Record at S893 (Jan. 31, 1989).

--How will insured deposit taking be segregated from risky securities activities in order to avoid the moral hazard problem and competitive imbalances?

--How will we guard against confusion by consumers between insured deposits and uninsured securities issued by bank affiliates?

--How will we be able to implement a system of functional regulation if the same entity is engaged in both banking and securities activities?

Each of these questions reveals the serious shortcomings of the universal banking proposal. These problems, in turn, result from an important difference between banking in the United States and banking in most Western European countries.

In Western Europe, deposit insurance is, for the most part, private and voluntary. This is the case in West Germany, France and Italy.*/ And, in those "universal banking" countries that have universal, government deposit insurance, such as the Netherlands, the level of insurance is far less than the equivalent of $100,000, which results in substantially less risk to the public.

A combination of "universal banking" and universal deposit insurance is modeled, then, not on Western Europe, but on Eastern Europe, where there was a philosophy of providing public guarantees to all sorts of business activities. I don't think that recent history shows that this road is a promising one.

An alternative would be to adopt completely the Western European model and to eliminate, or substantially reduce, the scope of deposit insurance. Yet this runs the risk of confusing and upsetting the legitimate expectations of depositors. Additionally, this would force banks that wish to remain traditional banks, such as community banks, to reduce their deposit insurance even though the same risks are not present. We feel the better approach is instead to circumscribe the activities that federally insured deposits can support.**/

We also wish to question the premise underlying the call for universal banking--that it is necessary in order for U.S. banks to compete internationally. Much has been made recently of the fact that there are no American banks in the "Top Ten" banks world wide in terms of asset size. But this fact does not mean that those banks are unable to compete. Indeed, as was pointed out in April 3 testimony before this Committee, American banks are generally more profitable then their larger foreign counterparts. In fact, American banks are smaller for a whole variety of reasons, including the remaining restrictions on interstate branching. Certainly, no one believes that the deposit insurance system should be subjected to unneeded risks simply in order to allow Citicorp or Chase Manhattan to make a Top Ten list in American Banker.

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*/ See "Deposit Insurance Schemes", unpublished FDIC paper (May 1989).

**/ In addition, we note that as Congress and the Administration continue to study deposit insurance, increased concerns have been expressed that placing insurance on a sound actuarial basis may result in prohibitively high premiums. This is another reason to reduce bank portfolio risks.

However, if the money center banks truly believe they need to combine commercial lending and securities activities in order to compete, we say fine. But keep federal deposit insurance and the taxpayer out of it. That is the essence of the narrow bank proposal and that is why we endorse it.

D. Regulatory Structure

Any changes in the legislation and regulations governing financial services must be accompanied by corresponding changes to the regulatory structure that will oversee the new system. I would like to set forth the Institute's views on what changes are necessary.

The Institute has long supported the concept of functional regulation, under which similar products are subject to the same regulatory controls regardless of the type of financial institution offering the product. Quite obviously, as banks are increasingly permitted to enter the securities business, functional regulation becomes more important both for the protection of the public and to ensure regulatory consistency.

Under current law, banks have not been made subject to the same regulatory controls as other providers of financial services. For example, banks have been permitted to engage in a wide variety of brokerage activities and to serve as investment advisers to mutual funds and others. Yet banks are currently exempt from registration and regulation as broker-dealers under the Securities Exchange Act of 1934 and as investment advisers under the Investment Advisers Act of 1940. Thus, in these areas, the SEC has no regulatory authority over banks even though they are engaging in the same types of activities, which raise identical investor protection issues, as entities over which the SEC does have jurisdiction. Even if Congress chooses not to grant banks additional securities powers, then, legislation is still needed to close these regulatory gaps.

In addition to these current loopholes, we question the wisdom for other current disparities under the securities laws between banks and others. For example, both the Securities Act and the Securities Exchange Act contain exemptions for securities issued by banks. SEC Chairman Breeden has called for removing those exemptions and we endorse this view.

We also believe that functional regulation casts additional doubt upon the universal banking notion advanced by certain major banks. While it may be theoretically possible to subject the same entity to oversight by one regulatory body with respect to its deposit-taking functions and to another with respect to its securities activities, we question how such a system would work in practice. Would, for instance, such a financial institution have to meet two different standards for minimum capital? It must be borne in mind that banking regulation and securities regulation have traditionally served two very different functions. The emphasis of the former is on the safety and soundness of the regulated entity. Securities law, in contrast, has not sought to prevent risks but, instead, to provide customers with full and fair disclosure of these risks. Subjecting the same activity to both types of regulation, then, runs the risk of duplicative and perhaps inconsistent standards.

In contrast, if securities activities are required to be carried out through a separate affiliate, functional regulation should be much easier to implement. The concept of functional regulation, which everyone seems to support, provides an additional reason to adopt the type of legislative program endorsed by the Institute, rather than the universal bank.

But functional regulation under the existing regulatory scheme may not prove adequate to regulate a revised financial services industry properly. A question has arisen whether there is a need for some sort of "super-regulator" to oversee all firms engaged in financial services, or affiliated with such firms.

The Institute believes that the arguments in favor of the establishment of such a regulatory system are not without merit. If one accepts the argument that it no longer makes sense to impose barriers between the provision of different types of financial services, it seems that it would follow that it makes equally little sense to fragment regulation in such a manner.

However, if taken to its logical conclusion, we would ultimately be forced to conclude that this regulator's jurisdiction would extend over the entire economy. In effect, it would become something very similar to the NRA of the 1930's.

We believe that such an entity would have too much power and that its establishment would be contrary to some very fundamental principles of this nation, such as the limited role of government in managing the economy.

For the reasons I mentioned above, however, as the interrelatedness of our financial markets and the firms doing business in those markets grows, we believe that there is a need for the establishment of a body that would serve a more limited function, specifically, to oversee and coordinate financial regulation. One model for this would be the Working Group on Financial Markets, also known as the "Gould Committee". Another possible model is the proposed Financial Services Commission, the creation of which is part of legislation introduced by Senators Wirth and Graham.*/

This regulatory body could, for example, work to ensure that examinations of firms with both banking and securities affiliates satisfy the needs of the appropriate regulatory body, so that duplicative and costly examinations are minimized. In the same manner, reporting requirements might be steamlined to minimize duplication. Such a mechanism also would help to assure that information relating to abuses and wrongdoing would rapidly flow to all interested agencies.

Thus, the Institute believes that there is a need for a regulatory body that would work to assure harmonization, effective law enforcement and the creation of an even regulatory playing field.

E. The Need For Special Investment Company Firewalls

As I discussed earlier, the Institute endorses the narrow bank proposal, together with appropriate firewalls, as a means to protect the insured bank and its depositors. Most firewalls contained in previous legislative proposals have focused on these concerns.

However, as we have testified before, if banks are granted broad securities powers, including the ability to sponsor and underwrite mutual funds, another set of firewalls is necessary, one that protects affiliated mutual funds and their shareholders from conflicts of interest and other possible abuses arising from bank sponsorship of mutual funds.

The Investment Company Act of 1940 contains numerous provisions designed to protect a mutual fund and its shareholders from possible conflicts of interest on the part of securities firms that sponsor or advise the fund. For example, Section 17(a) of the Investment Company Act forbids a fund's adviser from selling securities to the fund.

However, the Investment Company Act does not contain provisions that address conflict of interest situations that might arise when an affiliate of a commercial bank serves as sponsor or adviser of a fund. The reason for this is simple--it was thought at the time that the Glass-Steagall Act prohibited bank affiliates from serving in that capacity. As former SEC Chairman Ruder has testified:

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*/ S.2433, the "Financial Services Commission Act", Congressional Record at S4246 (April 5, 1990).

> [B]ecause the two Acts were drafted in the context of the separation between banking and securities mandated by the Glass-Steagall Act, they do not adequately address the conflicts and other investor protection concerns that will arise if banks are permitted to engage generally in the investment company business.*/

Thus, the absence of special firewalls did not mean that Congress thought that these conflicts did not exist.

Indeed, quite the opposite was true. Many of the abuses of the 1920's and early 1930's that led to the adoption of the Glass-Steagall Act involved bank sponsored mutual funds. For example, the public invested in funds that bore the banks' names, mistakenly believing that the funds were backed by the banks. The possible dangers from such confusion are, if anything, more pronounced today due to the presence of federal deposit insurance.

For this reason, the Institute has advocated that mutual funds sponsored or underwritten by a bank holding company affiliate be statutorily prohibited from having a name the same as or similar to that of the bank. We continue to believe, especially in light of recent events, that such a provision is necessary in order to avoid investor confusion.

At the very least, Congress should adopt such a prohibition for an interim period, for example three to five years from the passage of restructuring legislation. The Institute recognizes that the world is not static and that, at some date in the future after restructuring legislation has been enacted, the public may understand that a bank affiliate may sell uninsured financial products, some of which may be similar to the deposits held by the bank. However, it will take some time before that becomes common understanding. Therefore, it is vital that strict limits be placed on the names of bank affiliated mutual funds, as well as other possible sources of investor confusion, for an appropriate transition period.

Aside from investor confusion, many of the abuses that led to the adoption of the Glass-Steagall Act stemmed from conflicts of interest due to the affiliated bank's role as commercial lender. These included such practices as the investment by bank-sponsored mutual funds in securities of companies of which the bank was creditor, for the purpose of bolstering the financial condition of the borrower.

For these reasons, as part of any legislation that extends mutual fund powers to banks, it is vital that the federal securities laws be amended to provide protections against these types of conflict situations. Former SEC Chairmen Shad and Ruder, former Federal Reserve Chairman Volcker, the North American Securities Administrators Association and the House Committee on Government Operations have all recognized these needs and suggested specific safeguards that Congress should consider. Many of these protections were included in the Glass-Steagall reform bill approved in 1988 by the House Energy & Commerce Committee.

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*/ Reform of the Nation's Banking and Financial Systems: Hearings Before the Subcommittee on Financial Institutions Supervision, Regulation and Insurance of the House Committee on Banking, Finance and Urban Affairs, 100th Cong., 1st Sess., Pt. 2 at 554 (1987).

The Institute has drafted a series of firewalls that we believe are necessary for the protection of investors if commercial bank affiliates are allowed to sponsor and underwrite mutual funds. We have previously submitted them to this Committee.*/

III. A PROPER APPROACH TO REFORM OF THE FINANCIAL SERVICES INDUSTRY

I have tried to set forth what the Institute believes are the four guiding principles that should underlie reform of the financial services industry. The Institute believes it important that each is reflected in any legislation.

Equally important is that these matters are addressed in a comprehensive manner and in the proper forum, the Congress. In the past, unfortunately, this has not been the case. As I mentioned, some recent legislative proposals have simply provided for additional bank powers, without addressing the protection of federal deposit insurance, without providing for regulatory safeguards to protect investors, without functional regulation and without establishing a fair field of competition. We hope that this Committee and the Congress will carefully consider all these issues.

Even more troubling have been the actions of bank regulators to bypass Congress and to enact fundamental changes in our system of financial regulation, at the same time that Congress is considering these very issues.

In fact, there is a very recent example of this, which I think offers a perfect illustration of how financial deregulation should not be accomplished.

On February 1, the Comptroller of the Currency proposed to eliminate historic safeguards imposed on the operation of bank common trust funds, including restrictions on the advertising and mass-merchandising of these funds. In effect, this proposal would convert what had heretofore been simple administrative devices for the management of preexisting trust assets already managed by the bank into publicly offered mutual funds.

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*/ Legislative Proposals to Restructure Our Financial System: Hearings Before The Senate Committee on Banking, Housing and Urban Affairs, 100th Cong., 1st Sess. at 365 (1987)

If adopted, the Comptroller's proposal would grant banks significant new securities powers, and effectively repeal the Supreme Court's 1971 decision in *Investment Company Institute v. Camp*, which held that the Glass-Steagall Act prohibits banks from sponsoring and underwriting mutual funds. Additionally, the proposal would violate *all* of the principles I have discussed here today.

For instance:

--The funds will be sponsored and mass-marketed *directly* by the banks, rather than by separate affiliates.

--The funds will be sold *on the premises* of the banks, thus opening the way to public confusion regarding the existence of federal deposit insurance.

--This confusion will be exacerbated since the funds will bear the *bank's name*.

--There will be *no* firewalls designed to protect the bank, the federal insurance fund or the investing public.

--Banks which manage and mass-market these funds will be exempt from SEC regulation under the Investment Advisers Act of 1940 and the Securities Exchange Act of 1934.

--Banks will have been granted new securities powers, while securities firms remain unable to engage in banking.

Even more troublesome, however, is that the resolution of these and other issues will be undertaken, not by Congress, but by the Comptroller.

The Institute therefore urges that this Committee continue its work to adopt a comprehensive legislative program that contains the necessary protections for the public and provides for fair competition. At the same time, we urge this Committee to act to prevent the Comptroller from circumventing this process.

IV. CONCLUSION

The Institute recognizes that our proposal represents sweeping reform. However, we believe that at this point in time there is a real opportunity for Congress to respond to the demands for increased competitiveness, coupled with proper safeguards, and to restructure the financial services industry in a comprehensive manner. It is essential that this process avoid piecemeal reform and that it address the very real depositor and investor protection issues previously governed by Glass-Steagall.

The turbulence in the securities markets, the S & L crises, the LDC debt load assumed by our banking system, and the exposure of fraud and other irregularities in our financial institutions and markets leads me to the belief that the American public will be more interested in the outcome of this legislative effort than we realize from the day to day reactions to these hearings. It behooves us all to work towards an outcome which will preserve and enhance the credibility of our financial system and the soundness of its regulation.

The Institute appreciates the opportunity to testify here today and we look forward to working with this Committee in the future.

The **Chairman**. Thank you as well for a detailed and thoughtful analysis. It's helpful to us.

I'm going to start the questioning. Senator Pressler is here and when he returns I will recognize him for any comments he would like to make.

Mr. Whipple and Mr. Vallandingham—Mr. Silver makes a point about having some kind of an oversight body at the top. This oversight body would somehow pull together overseeing the separate functional categories in a revised system. What would you see in that area, Mr. Whipple? What do you think would satify the public interest and yet meet your practical concerns?

Mr. **Whipple**. I think that's exactly the question, Senator, and that's if we can devise something that would be effective and yet workable.

The Financial Services Council has developed some ideas on an oversight committee that would have coordinating responsibility. If you can envision the sets of firewalls that we're talking about, the sets of kind of functional boxes, there is a lot of information that's both available and needs to be coordinated in some way by some overseeing agency.

The way we would like to see it work is that would focus on the lines between those functional boxes and the holding company, if you can envision that kind of a structure, and make that line as tight as possible. Transactions across the line, for example, between those boxes and the holding company ought to be very strictly monitored not only from the view within the box which is the strong functional regulator, but by the coordinator as well.

The only note of caution I'd put in there is I don't envision in that process having to create a superstructure that in our case, for example, would have to know the ins and outs of the global automobile business in order to structure that. I don't believe that's necessary. There is lots of information available, lots of organizations that are expert in that information as the commercial business of how the Ford Motor Co. operates, but yet this oversight group could take a look at these lines, could have enough expertise to know of warning transactions, of market signals such as credit rating changes on the part of the holding company or the functional company, for example, and could make sure that the pertinent information was available.

That's a little bit of a hazy concept at this point, but that's how we envision such an overseeing committee.

The **Chairman**. Senator Pressler, let me ask you to make any initial comments you might want to make at this time.

Senator **Pressler**. Thank you, Mr. Chairman. At the proper time, I do have a question for Mr. Vallandingham as he represents the Independent Bankers.

I know in his prepared statement he refers to the severe burden on community banks of regulatory requirements and paperwork. My bankers in South Dakota have told me repeatedly that this is an ever increasing problem.

Do you think it is feasible for your members and association to pinpoint existing burdens of this kind, excessive paperwork, for example, so that the regulators and perhaps Congress can take steps to reduce the burden?

The **Chairman**. Now, Mr. Vallandingham, I want to give you a chance to respond.

Mr. **Vallandingham**. As a matter of fact, recently one of our members, a banker from Chicago, invited some staff folks from his Senator's office over and gave them a working example of the type of regulatory burden that the community banks and all banks for that matter are faced with.

It was very eye-opening and we have just recently put an article in our magazine as a follow-up on what community bankers might do to work with their legislator to show them the kind of difficulties we are running into and the burdens that are being created.

We hope that that's exactly what your community bankers in your home State will do, sir.

We are for the first time maybe beginning to identify in a way that legislators can really understand the total burden and I think it will be very helpful.

Senator **Pressler**. Thank you.

The **Chairman**. Let me just acknowledge that Senator Dixon must leave for another responsibility, but he's asked that his statement be included in the record and we will so make it a part of the record.

STATEMENT OF SENATOR ALAN DIXON

Senator **Dixon**. Mr. Chairman, I am pleased to be here this morning as the committee continues its current series of hearings on modernizing financial services law. We have a good group of witnesses appearing today. Their testimony will assist the committee as it considers how best to address the reform issues.

There are a wide variety of views on what constitutes reform, and reasonable people can and do differ as to what sound public policy is in this area. I hope, however, that there is no dispute on one point—that Congress, by law, should determine the framework that governs financial services.

Unfortunately, Congress has not been able to act on significant reform legislation. The regulators and the courts have therefore stepped in and acted. There are those who criticize the regulators and the courts for doing so. However, I want to point out that, by and large, they were only doing their jobs. They were not seeking to take leadership in this area away from the Congress. What they have to do, however, by law, is to respond to cases that are brought before them. And since Congress has failed to act for so long, parties seeking change have brought a number of major cases.

In the past, there were those who say we should impose a moratorium on further action by the courts and regulators. I was one of the architects of the temporary moratorium in the last Congress. I hope the calls for a moratorium will not be renewed this year.

Moratoriums are no substitute for addressing the fundamental issues that must be addressed. This is one Senator, therefore, that will not vote for another moratorium. Congress should act on permanent legislation to resolve the many issues that are pending. Further temporary moratoriums will not solve anything.

The **Chairman**. Mr. Vallandingham, if we end up with some restructuring along the general lines of what many have suggested and we get into a broadened set of powers with functional regulation, what would you or your organization see as the kind of policy coordinating board or oversight mechanism that might span the collection of functional regulators? Have you thought about that?

Mr. VALLANDINGHAM. We've given it some thought. As we have stated in our testimony and at other times, we are certainly not convinced that firewalls work. So any time we look at that type of a structure we have to question it and its whole validity. We also have to question an additional governmental body making us more efficient in delivering services because it does create the kind of burdens that we're talking about in the regulatory type burdens.

We have some real serious questions for small banks, for community banks, as they take on these additional powers, how they can really be structured and overseen in a way that they can fully understand the issues. We recognize that if we expect the FDIC, for instance, to give community banks guidance in securities law that probably becomes somewhat unrealistic.

So in answer to your question, we're skeptical of additional oversight boards but we also recognize that there are times—we think the State, for instance, insurance departments very sufficiently handle the law and the requirements in the insurance area, as the real estate in most States again has a department of their own and licensing processes, et cetera. But I don't know that we have arrived at a way that we think is fully functional.

The CHAIRMAN. Let me just make a comment about one of many lessons that have come out of the savings and loan problem that occurred over a decade. We're going to see eventually probably 500, 600 or 700 S&L's go down for a variety of reasons. Yet the much larger number of companies in the industry, of which Ford Motor Co. in recent years is one, are out there and they are doing pretty well and they are plugging along. This is not to say that it's easy, but they are in a profitable position and solid with respect to capital standards and so forth.

Yet, given the nature of the collapse of the industry as it was occurring, the well-managed S&L's were being put in jeopardy every single day by the ones that were not well-managed.

Now the general fallout and the difficulties are tending to wash across the whole industry. So the innocent are hurt by the guilty or by those who did not manage their affairs properly.

We did a lot of systemic changes in the savings and loan business in the 1980's that were supposed to make the industry stronger and it looks like in combination, for a variety of reasons, it had the reverse effect. The problems were not solved and they got worse and now we've got a major problem to have to rectify.

Yet down through that period, the healthy side of the S&L industry was not in here beating down the doors saying, "Look, these other things are going on that are in effect putting us in jeopardy and we think may sink the whole industry." There were a few voices, but relatively few.

When independent bankers think about it, hypothetically, if we get a new structure with a different set of powers and maybe risk profiles and what have you and we don't do it right, it seems to me we might run into the same situation where the innocent get blindsided by the others. I don't necessarily imply that every case was malfeasance or corruption, but certainly a number were. There were a lot that just went down because they didn't know how to do it properly in that environment.

What about the issue of whether or not your industry would see that as a material risk. It seems to me that community bankers or independent bankers have a much narrower playing field for the most part. I would think, by and large, you're out in the community in West Virginia and so you know that ballpark and that's the ballpark you play in. I don't imagine you're buying too many Brazilian bonds or speculating in currency futures or a whole host of other things. You're not interested probably in getting into investment banking any time soon or a lot of other things.

So in a situation of a radically transformed system whether a large part of the industry, even if it's a minority share of the total gross volume of the banking business of the country, might not find itself in a situation where it could get blindsided. If it didn't work right, you fellows might end up taking the hit even though you had stuck to your knitting. Isn't there some risk of that here? Do you worry about that?

Mr. VALLANDINGHAM. We do have those concerns, Mr. Chairman. Basically, those are the type concerns that lead us to take the position that we would like to see new powers granted in a step-by-step process. It leads us to the position of our recommended bill, the Consumer Financial Services Act, which is basically a brokerage approach rather than getting into underwriting and the riskier side of some of these other businesses.

We think that there has to be oversight of risk. Back to your oversight question, there is no question in our minds that there has to be some oversight of risk. You've really sort of led us into some of my ending comments in that we have said that we think it worthy of looking at a two-tiered system or a system that measures one group based on their conservative type approach to banking versus another group who makes a management decision that they might want to take on riskier endeavors and riskier products.

While we have concluded that that's worthy of study and worthy of looking at, we see, for instance, brokerage of insurance, real estate, and securities as far different than those that would choose to be a real estate developer or invest in real estate development, or choose to do underwritings of securities and insurance.

So we think they have to be measured differently. We think it's time that we look at that whole approach and say there's probably two avenues that banking is going to take and accordingly they offer different risks to the fund.

The CHAIRMAN. Let me ask you this. This is another question that's related that might be of interest to Senator Pressler because he comes from a more rural State. That's the question of these sweeping changes that have been taking place in the last several years in financial services and the rise of all kinds of competitive deposit-taking institutions, whether it's in brokerage companies that offer a form of money market account or others of a variety of ways in which money is collected by savers in a community and then invested in turn.

As you look at the pattern are you finding that a larger share of the deposits or the savings that are accruing in your community are going to entities that are distantly based? For example, though they may have an office in your area, basically the decision making and the center of where that activity is would be in New York City or some other distant spot. Would that be the case?

Mr. VALLANDINGHAM. That is the case. That's quite evident in our market and all community bank markets as well.

The CHAIRMAN. Now when the money gets collected in these variety of forms out in your community—the savings pool gets broken up and it goes off in different directions to savings and loans, commercial banks, money market mutual funds, whatever—what changes have we seen in terms of how much of the savings come back into the community? Obviously, not all does because the nature of our system is the money is going to move to where the opportunities seem greatest. So I assume when the savings go out of your community they can be invested in some other part of the United States, they could be invested in Brazil, they could be invested anywhere, and are, in terms of the effort to try to achieve high returns and so forth.

One of the issues which tends to get buried under all of the technical, specific debate here is the question of whether or not savings out of the community are in sufficient amount and are making their way back into the community for its preservation and development and long-term strength. Now some might say, well, let's not get stuck on that because you're going to end up with a very inefficient economic system if you don't let money move more readily than that. So I'm not here to advance that argument in any overall or complete way.

But I'm wondering if we have a dimension here at work that we need to think about. When you go back to the deposit system, when you go back to the payment system—which is actually what the banking system is still the centerpiece of—you've got this tie-in to the way we manage the availability of resources through the Federal Reserve System. Then you've got Federal deposit insurance underneath it all. Are we finding that the savings out of a community are in sufficient amount and making their way back into the community itself to just preserve the community in some sensible balance so that it isn't financially exhausted. Or is it exhausted, because its savings are rebated out and sent some other place. Then after a while, the community sort of dies on the vine because it's not able to reinvest in itself. Yet you still have all of this government support system around it.

Nobody is talking about taking that support away, by the way. Everybody I hear is saying let's keep deposit insurance, let's maybe change it. Nobody is saying let's get rid of the Federal Reserve window and the whole connection there. Nobody is saying get rid of the payment system. So all of that stays in place, but I'm just wondering how do we conceptualize this connection back in a changing age in a global economy to the question of how do we define and meet the community needs. Or can we, any longer?

I'm going to ask the other two to respond to that as well, but let me start with Mr. Vallandingham first because I've addressed the question to you, sir. Then I'll go to Mr. Whipple.

Mr. VALLANDINGHAM. Well, that's a very complex question, Mr. Chairman. I think that we can meet the community needs as long as we can be a source of funds to small business and the company that creates jobs in those communities. The jobs create other demands and the other demands create credit allocations. But it seems to me that the real nutshell of that whole question is how do we meet the answer to the small businessman's credit allocations? We think community banking has long done that and has been the keystone to that and as long as we can remain competitive in the marketplace in attracting funds, we will have the capacity to do that.

Our concern would be whether community banks were so disadvantaged that they no longer had the availability or the benefit of being able to attract the funds and therefore wouldn't have the opportunity to make that credit allocation back to the guy that's creating the jobs in the community.

Being from West Virginia, I well recognize the need for jobs. I have witnessed a State that in the late 1970's was very much on the move with a booming coal industry; then back to the early 1980's when it was very much devastated, with high unemployment, and a great amount of problems from lack of jobs, and a total need for revamping an entire job structure.

So it's my personal opinion—and I think one that all community bankers share—that the key to your question is the ability to be able to attract those funds fairly. One of our greatest concerns about the too-big-to-fail doctrine is that it's obviously a safer haven for money to be in a bank that can't fail than one that can and has deposit insurance. If deposit insurance were lowered, for instance, it would even become more likely that we would see those funds flowing out from our towns and from our communities and away to the larger money center communities.

The CHAIRMAN. Let me say one other thing and then I want to go to Mr. Whipple because I want to put something else beside this. I realize this is sort of a large cosmic question and I'm not posing it just to take up the time, but I think we have got to have some understanding about what the nature is of the public need and the public requirements. That's the whole reason we're here in a public setting where Government is so heavily involved because all of this is designed to achieve public purposes, whether it's a strong economic system or keeping communities intact or what have you.

When we devised and put in place the savings and loan system as a discreet separate type of banking, if you will, institution, it was to aim home building and to try to foster homeownership. In fact, we felt so strongly about it that the industry was created for that very precise purpose. It was a dedicated, narrow focus. Then it got broadened; got way out of bounds and lost its shirt as an industry. Now has been brought back into bounds.

The example beside it was aimed essentially at home building and at homeownership, to foster the movement of enough credit conveniently, community by community, out to families and individuals so they could buy homes; that was the driving public purpose.

On banking, it was a broader set of purposes but I think you're right in noting that loans to small business—the commercial lending side as apart from home mortgages—to job creators as well as the other depository functions, payment functions and the credit allocations functions and so forth were sort of the centerpiece of your charter. They still are I think community banking. So I want to make sure in thinking about a radically transformed system that takes into account global economic realities and global banking and instantaneous transfers of money all around the globe in the wink of an eye, that we understand how that new system still hopefully connects to whatever these remaining and essential and core public purposes are. That's what I'm really driving at getting some illumination of here in our discussions.

Mr. Whipple, why don't you give me some of your thoughts.

Mr. **Whipple**. Sure. I'm fairly optimistic, Mr. Chairman, about both ends. I think, on the one hand, we've talked a lot today about global competitiveness. I think we need that. That's absolutely right. But I also believe that the business of being locally represented and competitive—there isn't any way that's going to go away. There isn't any way that we're going to move this country from 14,000 institutions to 6 or 12 or some low number like other countries have. Why?

There also isn't any way that the small community banks in the end need to have I think the identical funds cost, for example, that Citicorp is going to have. In the real world it's not going to happen that way. But they have something that can't be duplicated by a Ford Motor Co. or a Citicorp or anything else, and that's knowledge of the local community.

I think in the end that is, as we look at our business, one of the most significant competitive advantages. You might pay a little bit more for your funds, but you offer so much more to your customers in the way of service that your business isn't going to go away.

Let me just give you an example of that that's very close. It doesn't involve insured deposits, but in the Associates, for example, our finance company, we have 600 roughly small offices around the country. They are not in the Washington, DC's or the downtown Detroit's or places like that. They are in the smaller communities. There used to be people who said 10 or 15 years ago that that was a buggywhip business, it was going to go away. Because they are not a low-cost producer, because they are not takers of insured deposits, they have to operate at lower leverage than banks do and, therefore, their funds costs are higher. So to get the same return, they have to charge a higher price. And they do.

The reason they are able to be extremely successful and operate successfully is because they know the local market and they know their customers and they are willing to provide the service. If a person in a small town wants a home improvement loan, he doesn't immediately think of Citicorp. He thinks of his local banker who's been there all the time. I don't see there's any way that that's going to go away.

Instead, I think we ought to get back to the focus and not worry about legislating every detail of every single one of these banks or every single one of these commercial companies, but concentrate instead on the subject of one of your questions, on insured deposits. How do we make absolutely sure that insured deposits don't get used for things that we don't want them used for?

Ford Motor Co. doesn't want to sell CD's—Ford dealers—and doesn't want to use insured deposits to develop the next Taurus and Sable and whatever kind of walls we have to put in place to make sure that that happens, that's OK, but that's a manageable task. I think, as you said—you mentioned the payments system and insured deposits. If we keep focusing on those, then we can have both. We can have the management and the capital flow into making us globally competitive and we can have the smaller competitive advantage of local banks completely successful.

The **Chairman**. I want to come back to that. Mr. Silver, let me give you a chance to weigh in on that point.

Mr. **Silver**. First, the proposal we have suggested, the so-called narrow or safe bank, would not be universal. That would only apply to the financial conglomerates, those who wanted to cross product lines. Under the proposal we espouse, the community banks could stay exactly as they are so that the deposit insurance scheme for community banks will operate exactly as it does today.

But in commenting on your other remarks, I agree with you, of course. The genie can't be put back into the bottle nor should it be because it never really was there in the first place, except for the small saver.

Thus under the regime of regulation Q, large wealthy sophisticated investors, no matter where they lived, could move their money outside of the local communities and did so to seek the best return or they could buy CD's over $100,000 which were free of regulation Q constraints. The sea change which has taken place in the last decade simply permits investors of modest means to move their money to achieve the best returns. I don't think anybody would want to, even if we could, move back to a regime in which only large sophisticated investors could receive the best returns.

The **Chairman**. Let me just stop you at that point because I think that's a very compelling argument. But just to juxtapose against that some contemporary evidence, a ton of insured deposits were collected in this country and invested in foreign loans that have gone sour and they are not able to be paid back. There were big front-end fees on the front end. They looked very profitable. They looked more profitable than more boring close to home type alternatives. But a ton of money in insured deposit form was sent out of the country to invest in what turned out to be very bad foreign investments, if you think about it as a private company making an investment. Huge write-downs have taken place. Huge loan loss reserves have had to be set aside.

In the savings and loan system, a ton of money was taken through brokered deposits and put into junk bonds and is now coming back into the hands of the Government. So I think there are some yawning examples of money moving through the system off the strength of insured deposits, not just to attract the funds, but putting we as taxpayers on the line to have to replace the losses. And in the name of seeking higher yields here or there, we now see a pattern of incredibly mistaken decisions where huge losses are accruing.

I'll give you another example. That's in the puffing up of real estate values because we are now seeing that adjustment taking place in the commercial banking system all over the country. There are huge write-downs being taken and commercial banks in some instances are having to close because they just didn't get it right and they were out chasing high yields and so forth and they got spread out over very diversified and far-flung investment horizons. Lo and behold, it looked great at the time, the same as the way it did for a lot of the S&L players. There are different facts—I'm not saying they are exactly the same at all, I don't want to be misunderstood on that—but nevertheless, big losses have been run up.

I want to test our thinking here. We want to figure out how we get all of the benefits that we hope to get and as few of the negatives or at least fence off the risks of the negative if we're going to have it all connected to Federal deposit insurance.

But it seems to me that we've had some pattern of extraordinary losses being run up and losses that are making their way back to the deposit insurance system and to the taxpayer of this country. I want to make sure that as we go down the road that we at least learn from the lessons of history so that we don't get into a situation where we may lose our connection to what the whole purpose of the system was supposed to be even if it's a little old-fashioned and a little narrow in scope. We have to be careful that if we end up in a situation where we move off that, that we don't move in a dimension that creates a new risk profile that we may not understand until we're already very deeply into it.

I'm not saying that's the case, but I think those are the kinds of questions we have to raise and then answer on the front end.

Mr. **Silver**. I think I can give you at least two answers, Mr. Chairman.

First, let's get back to the beginning on Federal deposit insurance. It was not—and I wholly agree with you—it was not for the purpose of removing discipline from the system and allowing every bank in the country to invest in Brazil because there was no risk that they would be shunned by depositors who were concerned with weak bank balance sheets.

The **Chairman**. It was a perception of a higher yield.

Mr. **Silver**. Without deposit insurance, if anybody seeks those kind of assets, the public is going to be very wary of dealing with that kind of financial institution. So deposit insurance does take market discipline out of the system.

That's why we suggest that, at least in the case of the financial conglomerates and large banks that want expanded powers, that we control the asset side of the balance sheet by going to the so-called narrow or safe bank and recognize that the deposit insurance is really to give investors of modest means a good, safe place to save their money. That's it. And it ought to come back to that.

As far as all banks are concerned, there is one reform which has been suggested from time to time that I suggest ought to go to the top of your agenda: that is simply the discipline that comes from marking to market. Regulatory accounting from my point of view has turned out to be phony accounting. There is nothing like marking to market to import some discipline into the system and which also lets the air out of the balloon slowly as values change in response to interest rate movement. To carry assets on the books for years and years and years at inflated value and then let the whole system collapse at once simply makes no sense at all.

The **Chairman**. I don't want to stop you but I want to make sure the other two fellows have a chance to comment. Then I want to go to Senator Shelby. So, Mr. Whipple, do you want to add anything to this?

Mr. **Whipple**. I think just a couple of points, Senator. I think the examples you gave are excellent examples of where we failed not necessarily by deregulating the flexibility in terms of investment options that a financial institution can make but by a very bad job of supervision during the process, coupled with a bad job of monitoring and establishing the type of capital standards that ought to be in the business.

And whatever solution we come up with, I think we are going to have to pay more attention to the supervisory job. We're going to have to spend more money.

The CHAIRMAN. But, Mr. Whipple, we had some of the smartest people in the banking industry in this country making these decisions, some of the highest paid and some of the most renowned financial experts at the very top of the commercial banking pyramid, people whose names are well known publicly.

And if they couldn't figure it out, how is the regulator going to be smart enough to figure it out?

Mr. WHIPPLE. Just take an example at each end of the string. The really nasty things that were done by some of the people in the S&L business I think are of a different category. They were just out and out wrong things. At the same time, they were done in a business that wasn't supervised adequately and that didn't have adequate capital standards.

You take on the other hand—there were some pretty dumb things done by some of the New York banks too, but they didn't come close to failing, I maintain, because they were (1) better supervised and (2) better capitalized. So they could take their lumps on some of the bad decisions and still be ongoing, viable organizations.

I believe strongly that we have to get to that. It's appealing somehow, sometime to think that maybe we can compartmentalize all these insured deposits and only invest them in things that are absolutely 100 percent safe, but I don't think we would end up with an economic proposition if we were to consider that. I think we're going to have to step up to the fact that we have to get closer to what the institutions are doing with insured deposits in terms of the functional regulation and having people out there to see it.

In the S&L things, if you sat in each one of those large S&L's that were making some of those bad decisions, it would have been very easy for somebody to see. It wasn't a bad judgment on Brazil. It was an improper judgment on real estate valuation or real estate venture or some other kind of a venture and it could have been seen I think with the right supervision.

The CHAIRMAN. Well, we'll have to watch and see, but my guess would be that as we watch the next 2 or 3 years unfold with respect to commercial banking that mistaken valuations on real estate investments, on bridge loans in leveraged buyout situations may well show us some of the same pattern that we saw in foreign lending that came back to bite us pretty darn hard. I'm not trying to make a philosophic argument here. I'm trying to figure out the practicalities of how we have a balanced system that works here so that we don't get caved in with a series of unintended consequences, even with very smart people who earn a lot of money and who can end up making bad decisions and lose a lot of money and then turn around and say to the taxpayer, "By the way, we'd really like you to sign this check."

Mr. **Whipple**. We can't let that happen.

The **Chairman**. Absolutely not, but I think those issues are very much relevant to this discussion. Did you want to add something, Mr. Vallandingham?

Mr. **Vallandingham**. Yes, Mr. Chairman. I do believe that your concerns are coinciding again with our position that we think that there is some merit in debating the argument of those people choosing to take riskier routes being some way treated differently than those people that choose not to.

I don't know that I would concur with the narrow bank concept as such. I think we need to leave banking in America doing the traditional things they have done—again, providing jobs goes into that whole arena.

I would like to just comment a moment or two—I think it is important that community banks be able to gather their funds at an equitable cost. As was mentioned earlier, yes, we have the advantage of providing service and providing understanding of our market at a local level, but there is a cost to providing service and it's a people cost. We are required to put a great deal more labor into a given loan than those who are doing it in larger and in electronic type ways. So we have that cost.

We also have the burden in community banking of paying 88 percent, as I testified earlier—88 percent of our assets are funded with assessable liabilities we're paying into the fund, whereas some of the larger banks are paying a much smaller percentage. So that, again, is a cost of our funds that has to be passed on to that small businessman.

I think we just have to be concerned about getting the cost of funds that are available to small business in America up and above what's available to some of the rest of the economy and the rest of the world.

The **Chairman**. Senator Shelby.

Senator **Shelby**. Thank you, Mr. Chairman. Mr. Chairman, I've been at another committee hearing and I apologize for being late. I do have an opening statement that I'd like to be made a part of the record.

The **Chairman**. We will make it part of the record.

STATEMENT OF SENATOR RICHARD SHELBY

Senator **Shelby**. Mr. Chairman, I commend you for scheduling this morning's hearing on the subject of financial modernization. We have a good panel of witnesses before us today.

I have read the testimony of this morning's witnesses and once again am struck by the divergence of views in the financial services industry. Glass-Steagall has resulted in a fragmented, specialized financial services industry and we cannot expect representatives of different sectors of the industry to espouse more than parochial views.

And the process will benefit from this. Small banks can point out very real problems in permitting banks to do "X" just as mutual funds can and securities firms can. Banks can identify why securities firms should not be permitted to do "Y". All witnesses see the crucial need to protect the deposit insurance system, but they would do so in vastly different ways.

We have a long process ahead of us, Mr. Chairman. What we did in 1987 and 1988 is not going to be sufficient now. The competitive challenges from abroad are more evident than ever and I believe that to adequately address the need for financial modernization, we must ensure that we have met those competitive challenges. I trust that today's witnesses will help us in this effort and I look forward to their testimony.

After that, I would like to follow-up on some things that the chairman has been getting into.

We've been holding a series, as most of you know when you're in the business here, on the modernization of the financial services industry. A lot of that has been churned or driven by events in the marketplace as we know over the years, but something that bothers me and it's bothered the chairman here is that things have a way—and I believe this is his phrase—losses making their way back to not just the people who put up some money and have an equity interest, but losses back to the deposit insurance; or in the thrift industry, the savings and loan insurance corporation it was.

What does that really mean? Everybody knows we're talking about the taxpayer sooner or later. So when we're talking about really modernizing and giving bank powers to the banks—which I have supported to some degree and the chairman has in this committee—should we open up the market totally to banks in that just about everything? I think that would be folly and I think that would be a mistake because how do you construct really what my colleague over in the House, John Dingell, talks about Chinese walls—how are we going to construct those walls so thick and so high that the American taxpayer or the FDIC fund—ultimately the taxpayer—would be protected?

I know we haven't done it. So I'm prefacing my remarks to get to this point. In the savings and loan catastrophe, we'll recall that a lot of the thrifts got into the real estate business as investors, as equity partners and so forth. It seems that if we let the banks into the real estate business then they are taking really no risks because the taxpayer, after the FDIC—where do we go from there?

Mr. **Vallandingham**. Well, I share your concerns, sir. At IBAA, we believe a step-by-step approach to deregulation has a great deal more merit than suddenly one day changing the way we do business. I think probably if history taught us anything in the S&L problem that we certainly have to recognize they would have been far better off to have gone step by step over a period of time into some of their other ventures, giving their personnel and their whole system a chance to learn how to do those businesses.

I feel that one of the shortcomings and one of the problems that happened in the S&L problem is that they made a very, very rapid transition without the appropriate time for a learning curve.

Senator **Shelby**. As Senator Riegle has used it and I alluded to it earlier—attribution—how do we keep losses from making their way back to the system and ultimately to us on this banking committee because if we're going to make public policy, and especially if we've learned anything from the thrift situation—I hope we've learned something because it just doesn't go away—how do we assure that the taxpayers won't take a hit down the road because of the FDIC? Let's hope it never is insolvent, but $14 billion or whatever is in it is not a lot of money in view of a lot of risk out there. So that's what I'm getting at. Mr. Silver.

Mr. **Silver**. Senator, I share your concern about firewalls and I share the chairman's concern about regulators. I do confess to some disquiet when I hear that the solution which most of the witnesses at the hearings thus far have offered to the Federal deposit insurance dilemma—and that is better supervision.

Well, we all say better supervision, but that is not an answer to the problem.

Senator **Shelby**. But if we had supervision but only supervision, yet everything was opened up—I mean it was just clear sailing ahead—you could get into anything you wanted to just about—the supervision would be immaterial, wouldn't it, because the risk would be so great?

Mr. **Silver**. Yes. That's why we are suggesting that the way out of the dilemma—and really the only way we've come up with—is that for the savers of modest means you control the asset side of the bank in financial conglomerates, not the community banks who just want to stay in their present business.

Senator **Shelby**. How would you do that?

Mr. **Silver**. By going to the narrow or safe bank for investors of modest means. That way you rely on rules. Don't rely on regulators or firewalls. If you control the asset side of the balance sheet, you will have a Federal Deposit Insurance System which will work for the small savers, and that's what the system is for. It's not for the large savers who ship their money across the country to banks that are going to accumulate large sums and invest them in Brazilian debt.

Senator **Shelby**. Mr. Whipple, I know you represent Ford.

Mr. **Whipple**. I was just going to make another of couple points in observing on the S&L problems that we've been through, would have I think been more help. One is if we had been a little smarter. That's easier to do by hindsight I know.

And the question of capital, more capital. Not only more capital in total, but more capital for the riskier businesses would have been a help.

We've talked about supervision. That also would have been a help.

I think the other thing that we've been talking about and I know there are some differences of opinion on the subject of firewalls, but it's taking some of these separate businesses, regulated and supervised by different agencies, and not mushing them together as part of the banks operation, looking at them separately, so that when you have the combination—a separate look, more capital, and early intervention—that is before the banks or S&L's become green debt or just completely unsolvable—I think would have gone a long way toward solving the S&L situation.

Senator **Shelby**. Well, more capital would be good because if you had more capital in any situation, that would mean that you would less likely to become belly-up, to become insolvent, and then take a hit on the fund.

Mr. **Whipple**. Absolutely.

Senator SHELBY. But it seems to me that even FDIC has lessened the need for capital rather than run it up. It accommodates a lot of the banks. It accommodates the thrifts and perhaps keeps some of them from going under for a while and therefore means that we don't have to come up with quite as much money here. But sooner or later, will a thin capitalization come home to haunt us?

Mr. WHIPPLE. Absolutely, it will.

Senator SHELBY. It always does, doesn't it?

Mr. WHIPPLE. Yes.

Senator SHELBY. Especially where the risk is out there and people can take the risk knowing or thinking maybe—not knowing but thinking the real risk is with the insurance fund and ultimately the American taxpayer. Is that right?

Mr. WHIPPLE. Absolutely. We have to make sure that by a combination of those things—the capital and the supervision—we don't just let that happen again.

Senator SHELBY. Well, Mr. Vallandingham, you represent the independent banks, how do we protect not Ford—Ford is going to take care of itself. They are well managed and well capitalized. But how do we take care of the small savers and small depositors in North Dakota, North Carolina, Montana, Alabama, and Texas and so forth that are in the small banks so to speak? If they are strictly in the banking business, if they go by the rules, they are not in all these other things, how do we do that? I feel like we have an opportunity and obligation of responsibility to these people, too. Mr. Whipple, do you want to comment on that?

Mr. WHIPPLE. I said a little earlier, I am fairly optimistic about that. I think the subject of local, competitive advantage is something that can't really be matched. I think we saw that in the real estate, if I could use that as an example. The S&L's that were successful in real estate are the ones that had operations in the local communities where they invested——

Senator SHELBY. And as the chairman has said, stayed with what they knew within the confines of their so-called mandate.

Mr. WHIPPLE. Absolutely. The ones that got in trouble are the ones that invested outside their home markets, tried to do it from a centralized operation, didn't have that local knowledge. I am extremely optimistic because we're in—I mentioned earlier again, we're in some businesses that aren't exactly banks but that make loans in the small communities, home owner improvement loans and second mortgage loans and things like that, and you don't have to be the low-cost producer. If you can be the high service, high provider, local expertise knowledge, you're going to win over. A New York bank isn't going to come in and take your business out. I think we can take very good care of the local community operations and have them be profitable and healthy and still worry about the other part of our conversation and that's global competitiveness.

The CHAIRMAN. If you would just yield—and I'm very admiring of what Ford Motor Co. has done, not just because they are a home State company, but your record is out there for everybody to see.

But on that very point and related to what Senator Shelby has said, if a loan company like Associates or Beneficial or whatever is going to step in and start doing a certain kind of lending in the community, they are going to do it at a higher interest rate. They are going to do it at a higher interest rate because that business is not working with insured deposits. So it's having a harder time attracting capital. However it attracts its capital, its capital cost is going to be higher.

I don't want to just talk about the Ford example. Forget somebody who's part of a big conglomerate and take anybody else. The person that comes in and gets that home improvement loan through a noninsured lending institution—we'll just pick any name—I don't know what the applicable rates would be, but they would be pretty healthy interest rates. They are probably higher interest rates than a home equity loan would be through a commercial bank or through a savings and loan institution. That would be my guess.

Mr. **Whipple**. They might be a little higher. I think they would be closer than you think.

The **Chairman**. Well, perhaps they are. That's why I'm asking the question because I don't want to make a supposition that's incorrect. I would think that the cost of collecting funds for the insured deposit institution is less simple because I think the deposit insurance helps attract deposits and helps attract them at a lower interest rate because you get the safety.

Are we in part seeing a transfer of function out of the traditional banking institution which was set up and still maintains all these important public connections and public support systems and advantages—very material advantages? And is part of that business, as traditionally done, being peeled off and sent down the street to somebody else to do? They may be doing it and they may well be doing it well, but they may be doing it at a higher cost and there may be an implication there. There may be something going on there in terms of the change and the nature of how credit is available and who gets it and what they pay for it that we need to understand better.

You're in this business each day and so you may be one of the most important people we can talk to because you're playing up and down the piano keyboard in a variety of different situations. I think it's much more difficult for policy makers today or regulators to be able to comprehend how this has proliferated and what's being split off and what's being done now in some other area in a different fashion that may in fact carry a higher cost to it and may in fact be less available in a community.

My guess would be that small businesses today are finding it harder to borrow in most communities across the country than probably was true, other things being equal, 10 or 15 years ago. That would just be my supposition.

Senator Shelby has yielded to me long enough.

Mr. **Whipple**. I'd like to make a comment on that if we have time a little later.

Senator **Shelby**. I believe you wanted to comment on Mr. Whipple's comments, Mr. Vallandingham.

Mr. **Vallandingham**. I wanted to return to your concern, when you're expressing the concern of protecting the taxpayer from the eventual loss that might evolve out of this.

Senator SHELBY. I think that's got to be the central thought going on in this committee, how we're going to protect the taxpayer down the road.

Mr. VALLANDINGHAM. I would concur with that and I would suggest to you that any insurer should look at the risk that's being posed to their fund and they ought to look at who is posing that risk and where the risk is really coming from.

It seems to me that we've kind of avoided in this country the recognition that a great amount of the cost to the FDIC fund has come from the failure of large banks when they weren't paying an equitable part of the premium for the funds that were protected. It's one of IBAA's positions that foreign deposits, if they are going to be protected, there should be a premium paid in. If you create a $900 million additional premium each year, your fund will build up fairly rapidly and it would build up and insure what it's really protecting. It doesn't seem logical that you would protect a group of funds over here that you collect no premium on. I have trouble relating to that concept in insurance. So I would suggest that that's got to be talked about and it's got to be looked at.

Second, I think earlier intervention would have made a great deal of difference in the S&L crisis and I think we all recognize that.

Senator SHELBY. What about regulation that Mr. Silver talks about where you know exactly what you can do and can't do, et cetera?

Mr. VALLANDINGHAM. The narrow bank concepts that I have read and thought about, I don't see how they in the long run serve the credit allocations of a community or a nation very well.

Senator SHELBY. But wouldn't that have saved or perhaps saved a lot of the heartburn that we're all having and money from the taxpayer? I don't know. I think it's debatable.

Mr. WHIPPLE. There are certain regulations that I think——

Senator SHELBY. If there were certain limits that were delineated as to what the thrifts could invest in and what they couldn't and maybe not the risky stuff.

Mr. VALLANDINGHAM. It seems to me that the lesson that we certainly have to look at or one of the lessons from the thrift crisis is their ability to gather deposits through brokered deposits and increase the size of the institution and the funds they had available very rapidly without additional capital and quite frankly without additional management. Then to take those funds out and invest them in what turned out to be very risky matters is certainly a lesson America has to learn and look at.

I concur there ought to be regulation. We advocate that brokered deposits ought to be controlled based on capital. I would concur that there have to be regulations or there have to be mechanisms put in place to drive the kinds of investments that institutions make with insured deposits.

On the other hand, I find it somewhat inconceivable to think that only basically those instruments that could be invested in by banking now without regard to lending limit, that very narrow group of instruments, I have a little bit of trouble how that would serve the credit allocations of our nation very well.

Senator SHELBY. Mr. Silver.

Mr. Silver. I think you've put your finger on it, Senator Shelby. In his written testimony, Mr. Vallandingham makes a very important point and it's one which my own experience and studies confirm. That is that it is virtually impossible to put the deposit insurance system on a sound actuarial basis as a private insurance company. The cost, the premiums would be absolutely prohibitive.

Senator **Shelby.** Why, though? Because on an actuarial basis you would assume the risk in the premium, would you not?

Mr. Silver. Huge risks require huge premiums, making the whole system unworkable.

Now if you start with the paradigm that the Institute proposes the so-called narrow bank, you obviously bring the risks down. But then, as the chairman suggested earlier in his comment, there are sacrifices to that. Perhaps you're raising the cost of capital because the lending in the local community has to come out of the uninsured affiliate and the cost of capital will be higher. But there are two sides of the same coin. There must be a recognition by the Congress that as you leave the paradigm of a narrow bank and broaden bank authority to, for example, make home mortgages or make loans to small businesses you increase the risk and you assume the responsibility for a contingent subsidy which is going to come home if things go wrong. As you suggested, Senator Shelby, and the chairman suggested—it will come back home to the American taxpayer. So that's the dilemma.

I'm glad I don't have to resolve it. But the point I would leave with you is that once you leave that narrow bank you move toward a system which admittedly is not actuarially sound, there is at least an implicit contingent subsidy.

Senator **Shelby.** That goes right back to what we were talking about when we are holding hearings looking toward making public policy dealing with modernizing our financial services industry. In other words, what is a bank? What can a bank do? Then what are the inherent risks that really they can take and what is the downside of those risks that we come in making this public policy or laws which says these funds are insured; and then ultimately, it revisits us—the taxpayers—and revisits us in the committee. So when we're holding these hearings and trying to make public policy, trying to decide where we're going to go, how far we're going to go, how we're going to go in modernizing these institutions, it comes back to one thing—oftentimes maybe not in every instance—that is, the deposit insurance fund because that is ultimately the big risk, is it not?

Mr. Silver. Exactly.

Senator **Shelby.** Other than the equity risk of the investors. Mr. Whipple, do you agree with that?

Mr. Whipple. Absolutely. I don't agree that the narrow bank is the solution to that.

Senator **Shelby.** I didn't say that either.

Mr. Whipple. But I certainly agree that once you depart from that, then you have to decide where to draw that line. We are going to be in the business of managing risk and we have to say how are we going to manage it. We can do the outliers. We can do the loans to Brazil and outlying all that kind of thing. But once you're talking about housing loans, loans to small businesses, loans to small companies, they all take degrees of risk in there and we just have to say to the extent that we are going to have those businesses, basically banks, maybe some day some other companies, be in the business of all of those and involve deposit insurance funds, then we have to put some restrictions on them. We are all agreed with that. There have to be capital restrictions and there have to be supervisory restrictions. We can't walk away from that.

Senator SHELBY. Let me pick up on something Mr. Silver alluded to and that is to make a fund actuarially sound because to make it actuarially sound it would have to be computed mathematically commensurate with the risk. All of you know that. We all know it. It's just a basic law out there.

Should we restrict the loss only to the fund in the FDIC fund? Should we do this here in Congress or should we do what we have already done and said, oh, we're going to stand behind the banking system if the banking system goes under—if the insurance fund goes under, just like we've done. Of course, we've already done that. Was that wise public policy?

I have a lot of constituents say they didn't do any of that. They didn't cause any of the mismanagement of the thrifts in Texas or in five or six in my own State of Alabama. So why should they as taxpayers have to do this? Then is it for the good of the banking system? Is it the glue that holds it all together? Is it, Mr. Whipple?

Mr. WHIPPLE. That's the whole deposit insurance debate that we are embarking on for the rest of this year. Again, I would come at it from the outer edge to say we certainly couldn't have had the kind of system that said let all those depositors in Texas that maybe took our savings and thought they were getting insured deposits, let's default on them. We couldn't do that. That's not a practical thing to think about.

Senator SHELBY. Let me ask you this, though. What do you have the fund for? Let's talk about FDIC for a minute. Since the other one is gone. In FDIC there is $14 billion more or less in the fund today? It's $14 billion in it. There's a premium that is charged to go into the fund to the banks. Is it fair for the taxpayer to pick up the loss? Let's say the banks—heaven forbid, but nothing is beyond the realm of possibility—let's say this $14 billion got wiped out because of bank failures fast. Is it fair to come up with another $200 or $300 billion if that were the case again for the taxpayers to do this?

Mr. WHIPPLE. We have to devise the kind of system where we don't get into that. If we did, we would have no other alternative than what we're doing in the S&L thing. We cannot tell people who we made the promise to that we are going to renege on that promise.

Senator SHELBY. I know that. Was it wise for us to do that? The President and the Congress and we were part of that. We passed the sense of the Senate resolution and said we're going to stand behind it and we're going to assure the little depositor in America nationwide, if you put your funds in these savings and loans or in these banks, that no matter what at the end of that insurance FDIC or FSLIC—it was in that case—we're going to stand behind it, with your money, the taxpayers' money out here, no matter what? Do you think that's good public policy?

Mr. **Whipple**. For the small depositor, I think that's where we are on public policy. For the larger depositor, I think we can raise among ourselves some questions.

Senator **Shelby**. Why do we need that fund out there? Isn't it a false and misleading fund if there's $14 billion out there and just like it was so and so in the thrift fund and look at the hits that we've taken. Ultimately, the insurance fund is the American taxpayer. And they don't like it.

Mr. Silver, do you want to talk about actuarially sound here?

Mr. **Silver**. I think you've put your finger on it. If the existing fund is not actuarially sound. And I haven't seen a viable scheme for a banking institution with very broad powers that can be insured on an actuarially sound basis without exorbitant premiums.

Senator **Shelby**. Mr. Silver, if the FDIC fund is not actuarially sound today—and I think that's probably a given—if it is not, why should we in Congress and here in the Senate Banking Committee be pushing to get some of the banks into some risky situations that we have reason to believe is going to revisit us just like the savings and loan?

Mr. **Silver**. Well, it seems to me that that would be going 180 degrees away from where you ought to be going.

Senator **Shelby**. It would mean that we hadn't learned anything if we do this, wouldn't it? From the savings and loan problem.

Mr. **Silver**. I think, sir, Congress always learns.

Senator **Shelby**. OK. I hope so.

Mr. Vallandingham.

Mr. **Vallandingham**. I would just say that as far as public policy goes and whether are you going to protect the depositors and institutions in this country is that you do have a total world economy that you have to think about. So to make a broad statement that we are not going to protect depositors of banks beyond the $14 billion in the fund probably takes more courage than any of us could mount in reality until we find the way to address that issue of how we're going to do that.

Senator **Shelby**. Do you think it would be wise for us to do that, though?

Mr. **Vallandingham**. As an American taxpayer and as banker, I would favor a world accord that said that we would allow our big banks to fail worldwide but I'm not sure that that's possible. Until that's possible, I think that America is faced with the possibility of a megabank failure at which time that bank will be made whole. As long as we have that situation in America and I think it will be here for some time to come, then we have to look at the whole scope of both domestically as well as foreign.

It would seem to me that the best policy would be to do something that would increase the amount of dollars in the fund to protect against the losses. Again, that's why I favor assessing foreign deposits and other liabilities. By 1996 our calculations are that the fund could be at $56 billion.

Senator **Shelby**. Mr. Chairman, I appreciate your indulgence. We're interested in similar things.

The **Chairman**. It's interesting. We're going to have 13 hearings this year where we're trying to really get into this debate and we've asked the major witnesses that we can identify who can really bring penetrating insight to these very difficult and ambiguous questions to come and share their thinking with us. We will be hearing from international representatives as well. We're going to look at the question of how the banking system works in Japan and how it works in Europe and how we really get to this question of how you interface national banking systems in an international economy. I want today's debate seen in that broad context. We're exchanging ideas here. Nobody should run out the door and assume questions I pose or that Senator Shelby poses means we're going one way versus another.

Senator **Shelby**. If the chairman would yield, he's saying we are probing. We're looking for the truth. We are looking for ways to go and ultimately we all are for a sound financial banking system but I keep going back that the American taxpayer is very unhappy with the money that it's going to cost for the FSLIC failure, for the thrift failure, and they sure as heck don't want any bank bailout I can tell you that, Mr. Chairman. So when we're getting into modernizing the financial services industry I think we have to keep that in mind as central to this whole situation.

The **Chairman**. Well, along that line, when we wrote the savings and loan reform package last year, we put a stop to every abusive practice we could identify, every single one. The complaints that are coming in now is that the bill is too tough. Nobody is complaining that it's not tough enough.

That came at the end of a decade of a lot of difficulty piling up. In terms of where we're going through the next several months, there are enough disturbing things going on in the market in terms of interest rates rising—we've had a falloff in the stock market over the last week. I don't know what it's doing today. I think we're down to about $13 billion in the deposit insurance fund for banks and there's well over $1 trillion in insured deposits protected by that. So we're talking about this pyramid balancing on a pretty fine point. No one can predict where we're going to be in 6 months or 9 months or 12 months with respect to the insurance fund. I have great confidence in Bill Seidman who's in charge of that, but $13 billion can disappear in a hurry when you're seeing real estate values evaporate on as broad a scale across the country as they seem to be. They started out in regional zones but it looks like there are very few regions right now that are exempt from a major reduction in value in real estate. There are some but it's a problem that seems to be fairly widespread.

We may not know. In the regulatory system, we spread very few regulators across an enormous system and you have to rely on accounting data. Often that data is not accurate and it's late and it can't be done in terms of valuations in the way you would like it to be done, so $13 billion could disappear in a hurry. I'm not forecasting that it will, but should it, I think we will find this debate gets caught up in that very quickly. That isn't very much of a cushion to have to burn through before all the sudden you're presented with a different question.

It's interesting, I think there's some analogy. When you get into asset valuation, you get into valuing credits, value can disappear in a hurry. What something is worth is what somebody is willing to pay for it. And it's like the stock market. All of a sudden if the psychology changes and they are only willing to pay this, then this is what it's worth and you've got a big write-down to take. People holding junk bonds have just found that out because of the savings and loan legislation requiring marking to market. That's been very painful for a lot of the big junk bond holders, particularly with a windfall drop in junk bond prices.

I think we have to put together a kind of reasoning in a structural model here that takes into account all of these items together and that means getting each item out and ventilating it as we go. That way, when we start reengineering the system we engineer something that's going to work and is going to hold together and can cross-connect with the deposit insurance system in a way that does not create an excessive profile of risk. We can think we've got risk under control and find that we thought we did but we didn't. I think now things are different. If the Comptroller General who was in here a week ago is anywhere close to accurate when he's now predicting that the ultimate losses in the savings and loan collapse may well run to a $½ trillion over 30 or 40 years, that is our current experience. I'm not saying that the S&L situation is analogous one for one to the banking system, but the issue of altering the system and ending up with a risk profile that is not going to put the deposit insurance system in any material jeopardy for the future is an iron test that anything is going to have to meet. There is just no two ways about it.

One of the problems we face—it is in diversification and it is in the name of broadened powers and so forth, but there's an echo out of the past with respect to the savings and loan experience. We got into trouble and profit margins were eroding, and savings and loans up through the 1980's were arguing for different operating authorities and the States went way beyond that—the State of California allowing State-chartered thrifts to have up to 40 percent of their assets in junk bonds, for example. If you explained that to people on the street today, they would just faint dead away because it just on its face seems just crazy for that to be the case with insured deposits, but that was the State powers anomaly. I can tell you this. I don't want to see any State powers anomaly in any revised banking system for the future. That's one that I feel strongly enough about from the tip of my head to the bottom of my feet that we are not going to allow that kind of problem to happen again and have the States out of control and help capsize the Federal deposit system because of that kind of a jeopardy.

All of that is by way of concluding to say that, in putting the system together down through the 1980's, the notion was if you diversified, if you allowed other activities—the Federal Government bought it and then the States added to it and so forth—the S&L's could make themselves profitable. They supposedly could work out of their dilemma with the elimination of regulation Q and interest rate ceilings and so forth. It didn't work out that way. It's a different situation but a lot of the same arguments are being made now, that it's time to deregulate, that competition requires it, let's get into new lines of business and so forth.

My experience has been that that's not easy to do. You can go into the other guy's business, but don't expect to be a success right off the bat because it always looks easier than it is and it's pretty darn tough to diversify and make a killing at it. People do it, but an awful lot of people try it and don't do it.

So when we tie it all back down to the Federal Deposit Insurance System while we're sitting there right now with a $13 billion cushion it looks to me like the cushion is shrinking some. It really puts this thing in bold relief and I think we're going to have to see as we go down through this debate, if the administration comes forward with a package sometime early next year which seems to be what they intend to do. Even that set of proposals will be taken up in the context of the situation that we find ourselves in at that time.

So some of this testing is going on right now as to how well the system today is working. I think you and I should expect that it's going to add some material dimension to our debate as it goes on, and as it concludes in some kind of a presumed legislative action or response that we make.

So, gentlemen, I'm going to give you each some questions for the record. We have gone at some length here this morning. I'd like to ask if each of you have some final comment you want to make and then I'm going to give you some questions you might respond to.

Mr. Whipple, if you want to just make any additional comment that relates either to my last comment or anything else that you didn't get a chance to say earlier, this would be a good chance to do it. Then we'll just go right down the table.

Mr. **Whipple**. I think I essentially made all the points we wanted to make in my initial comments, Senator, and the following discussion.

If I could just take 30 seconds to comment on one point you made on the middle market, kind of the smaller businesses sort of financing, it's not completely pertinent to the rest of our discussion, but that's an area of very hot competition now and I think it's well margined and quite good availability for the medium sized and smaller sized companies. Why? The big banks are pulling back from some of their overseas loans and oil kinds of investments and the competition is really not we're finding in the middle market end of the business.

The **Chairman**. That may be an encouraging piece of news.

Mr. **Vallandingham**. Mr. Chairman, first, I would like to say that what I heard here this morning from the committee and yourself is a great concern for safety and soundness and we share that concern. That is the keystone to our position as we see it.

I would make one comment about mark to market if I may. We have a great concern that mark to market would dry up credit to small business because quite frankly we don't think there is much of a market for those loans. So as you stated earlier, a product is worth what it will sell for and we really question that there's much of a market to sell a small business loan.

The **Chairman**. Mr. Silver.

Mr. **Silver**. Just one comment. At the risk of sounding like a monomaniac on the point, I think that you must go back—Federal deposit insurance is the key here and the soundest route to take is to bring it back to its origins. All it was designed to do was to give the modest saver a safe place to save, not to finance activities in a whole range of areas.

The **Chairman**. Gentlemen, it's been a good discussion and you have all added importantly to it and I appreciate the time and the effort an thought that you each bring.

With that, the committee stands in recess.

[Whereupon, at 12:30 p.m., the hearing was adjourned.]

DEPOSIT INSURANCE REFORM AND FINANCIAL MODERNIZATION

THURSDAY, APRIL 26, 1990

U.S. Senate,
Committee on Banking, Housing, and Urban Affairs,
Washington, DC.

The committee met at 10:10 a.m., in room SD–538, Dirksen Senate Office Building, Senator Donald W. Riegle, Jr. (chairman of the committee) presiding.

Present: Senators Riegle, Dixon, Shelby, Graham, Garn, Heinz, and Pressler.

OPENING STATEMENT OF CHAIRMAN RIEGLE

The **Chairman**. The committee will come to order.

Let me welcome all those in attendance and particularly our witnesses today.

This morning we are starting a little bit late. We have a number of things going on, including the markup of the budget in the Budget Committee. Some of us serve on that committee, so we will have to go back and forth between the committees today because of the nature of the pending business before the committees.

This morning's hearing is the fourth in our series of financial modernization and deposit insurance reform and regulatory restructuring. In the preceding three hearings we have listened to representatives of various banking and security industry trade associations as well as consumer group representatives and we have asked all of our witnesses, including today's witnesses, to address three questions.

First, how should the current system of Federal deposit insurance be changed, if at all?

Second, what should be done to improve the current regulatory structure?

And finally, should new powers be granted to banks or their affiliates? If so, what powers should be granted, when should they take effect, and with what protections for the deposit insurance fund?

Today's witnesses bring the perspectives of the real estate and insurance industries to the table. Both of these important industries have historically opposed the expansion of bank powers into their respective areas of activity.

Nevertheless, bank powers have steadily expanded, despite their opposition, especially in the insurance area.

The real estate and insurance industries also share the important feature of being largely unregulated by the Federal Government. This feature is important because many policy makers fear that unregulated or inadequately regulated entities in a financial services holding company would place large and uncontrollable demands on their federally insured affiliates.

On the other hand, many banks and some consumer groups, albeit not the consumer witnesses who appeared here last week, have long called for expanded bank insurance and real estate powers. Consumer groups have argued that added competition from banks will drive down premiums and agent commissions reducing the cost to consumers.

Banks contend the additional lines of business will allow them to diversify their risks and increase their profitability.

Both of these contentions, if true, would constitute arguments that the Congress would have to carefully consider. I might also say that, on the other side, the argument has been made over time about the possibility of tie-ins the fear is that there will be undue pressure for consumers and businesses to use other bank services so as not to jeopardize their banking credit relationship. So that constitutes still another issue that tends to be in this general debate.

Our witnesses this morning are Norman Flynn, president of the National Association of Realtors; William Irons, representing the National Association of Life Underwriters and a coalition of insurance agent trade associations; and Stephen Friedman, who is the executive vice president and General Counsel of The Equitable Assurance Society of the United States, on behalf of the American Council of Life Insurance.

I welcome them and after we've heard from our colleagues with opening comments, then we'll go to our witnesses. Senator Garn.

Senator **GARN**. Thank you, Mr. Chairman. In the interest of time I will just ask unanimous consent that my statement be placed in the record.

OPENING STATEMENT OF SENATOR GARN

Senator **GARN**. Mr. Chairman, I congratulate you for continuing this series of hearings on financial modernization and deposit insurance reform. The issues we will address today have been around for over a decade.

I look forward to hearing the testimony of these witnesses today. It is important, however, to remember that a hearing—though critical—is not an achievement. When we leave this hearing today, we will have accomplished little; the financial system will be unaltered by our discussions.

Nonetheless, the information we gain from these hearings further arms and equips us to make the needed legislative changes. By now, in fact, we should be fully armed and equipped to act—to finally set a course for the last decade of this century and beyond.

Mr. Chairman, I look forward to working with you and our colleagues on the committee to enact legislation that will set a course for the future.

The **CHAIRMAN**. Senator Shelby.

Senator SHELBY. Mr. Chairman, I ask unanimous consent that my statement be made part of the record and I will be real brief, Mr. Chairman.

I believe this is an important hearing today, as you do. You have scheduled many hearings dealing with us looking toward making public policy on the modernization of the financial services industry and I believe that one of the most contentious issues that we will address in attempting to deal with this is the issue of modernizing the financial services industry is going to be centered around real estate and banking powers. And as you keep focusing in on, how are we going to protect the Federal deposit insurance fund if banks get into this issue.

And I ask unanimous consent that my whole statement be made a part of the record.

The CHAIRMAN. Without objection. Thank you, Senator Shelby.

STATEMENT OF SENATOR RICHARD SHELBY

Senator SHELBY. Mr. Chairman, I commend you for scheduling this morning's hearing. I believe that the debate on how we address the question of real estate and insurance powers for banks will be among the most contentious of the issues that we will address in attempting to modernize the financial services industry.

I have read the testimony of today's witnesses and found it simple in its frankness. They are straightforward in their objections to seeing banks enter the insurance and real estate businesses and obvious bias aside, I believe they make very valid points.

Banks assertions to the contrary, I believe that a real opportunity exists for the inappropriate tying of services and other abuses. A prospective borrower—a struggling business, a young first time homebuyer—is rarely in the position to pick and choose among lenders. Oftentimes, timing is important if not vital and a borrower fearing delays or denials by other lending institutions would feel that accepting other services, such as purchasing an insurance policy from the institution is a small price to pay for access to credit.

What's more, insured deposits supporting other services would represent an unfair subsidy to which other providers of real estate and insurance services that remain unaffiliated with banks would not have access.

The thrift crisis has been an extremely expensive lesson on the shortcomings of deposit insurance. Financial modernization must minimize risk to the deposit insurance system; insurance underwriting and real estate investment can be extremely risky.

However, I support the entry of banks into the investment banking business because I believe that the differences between many products and services have become blurred beyond distinction. But many investment banking firms are affiliated with a host of other financial services companies, thus offering consumers banking, investment, real estate, insurance, and other products and services under one holding company umbrella.

This reality compounds the difficulty of trying to permit integration among some types of financial services while providing for safety and soundness and preserving a competitive marketplace for consumers. Resolving these conflicts over the coming months, as this committee attempts to delete archaic restrictions from U.S. financial law, will require patience and cooperation from the various participants. We look forward to working with you.

Thank you, Mr. Chairman.

The **Chairman**. Senator Pressler.

Senator **Pressler**. Thank you very much, Mr. Chairman. I do hope that the witnesses will address the issue that in the 100th Congress the Senate passed the Proxmire bill, S. 1886, by an overwhelming vote of 94 to 2. If failed to receive action in the other body. Nevertheless, what is your general thinking about the proposed legislation and some of the compromises that were embodied in the bill as it passed the Senate. I think that should be the focus of some of the testimony this morning.

Thank you, Mr. Chairman.

The **Chairman**. Very good. Before we start, I have a statement from Senator Dixon to be inserted in the record.

STATEMENT OF SENATOR ALAN J. DIXON

Senator **Dixon**. Mr. Chairman, I am pleased to be here this morning as the Senate Banking Committee continues its series of hearings on modernizing the financial services industry. I look forward to the testimony of each of the witnesses.

Last Congress we worked out financial modernization legislation, passed it out of committee, approved it overwhelmingly on the floor of the Senate. In committee we struggled a lot with the insurance provisions of that bill, but we did reach a hard fought compromise—a reasonable policy compromise at that.

Now that we are revisiting all these issues and more, I cannot help wondering whether the insurance industry would not be happier if we already had in place the 1988 Proxmire financial modernization bill.

I had re-introduced the Proxmire bill in January 1989. Time may have overtaken that bill by now, but the need to reach reasonable compromise and to go forward on that basis still remains.

The **Chairman**. Gentlemen, I welcome you again. Mr. Flynn, we will start with you. Let me say at the outset that we will make all full statements a part of the record and to the extent that you can summarize for us we would appreciate that. Mr. Flynn, we'll start with you.

STATEMENT OF NORMAN D. FLYNN, PRESIDENT, NATIONAL ASSOCIATION OF REALTORS

Mr. **Flynn**. Thank you very much.

Mr. Chairman and members of the committee, my name is Norman D. Flynn and I am president of the National Association of Realtors, which is an 800,000 member organization and portends to be the voice for real estate. Other than that, I'm a former chairman of the board of a national bank and served on a holding company bank board as well, although I've been off bank boards and have had no affiliation for the past 6 years, but I think over those 8 years understand fundamentally the basic practices of those banks and the general thrust of what banking is in general.

Real estate's interest in the bills and the deliberations that are before you frankly we see that it's critical to our institution and to real estate in general that our financial institutions preserve the safety and soundness of those institutions.

Second, that the public's perception and confidence in those institutions in no way be eroded; that new regulation or increased powers, whatever is considered by this committee, not increase the risk of those institutions of that confidence that seems to be eroded, particularly in light of the FIRREA legislation of 1989 and the substantial bailout of the savings and loan industry which is now underway.

Let me make some general background comments and let me also indicate that we have submitted written testimony and that these remarks that I'm making will not be directly related to that but as backdrop and framework for that written testimony. Following this, I'd be pleased to answer questions about the oral or written testimony as you might have them.

The first point is that the real estate business and other businesses that the banks seek to expand into are not inherently profitable. I cite as evidence that in 1978, which is regarded by most observers of the real estate business as the most profitable year ever with the highest number of sales and greatest housing starts in the nation's history, never to be duplicated over these past 12 years, during that most profitable year in real estate, 25 percent of all real estate companies lost money.

During 1989, the most recent survey we've done of real estate companies, over 55 percent of them had a net profit of less than 2 percent. Forty percent clearly lost money.

While many outside observers see large and even not so large real companies as inherently profitable, they are less and less profitable and it's an extremely competitive business; that our association has grown by nearly 30 percent in numbers, not only in numbers of agents but in numbers of companies, and in each of the communities which they represent is a highly competitive business.

Frankly, that banking necessarily is not synergistic with the real estate industry. Since I know most about those two, let me tell you why I think that is.

When I was actively involved in the banking business, we constantly tried to get the officers and directors and members of that banking community to be sales persons and marketing oriented. Their orientation is of credit and creditworthiness and analysis of credit and business. They are not good marketing organizations and I think today the financial community is not a good marketing business.

In fact, the attempts where State-chartered institutions have gotten into the real estate business because they were allowed to do it, they had increasing difficulty. In my own city of Madison, WI, the State's third largest savings and loan purchased the city's third largest real estate company, a then Coldwell-Banker affiliated company. Each passing month after the purchase, what had been the third leading company in market share in real estate in the city of Madison, over a period of 7 years dropped to the sixth largest. They dropped the Coldwell-Banker affiliation and as recently as 8 months ago sold that company at a substantial loss to one of the competitors and they are no longer in that business.

But worse than that, I look in the State of New York where Gold Dome, now in receivership, purchased the Realty World franchise nationwide and after a $2 million loss resold it at that loss and in fact in no small measure led to the demise of Gold Dome.

I cite as a further example Empire of America which purchased Gallery of Homes and had a substantial loss and finally sold it.

So in fact there is not instant synergism and real estate companies are not inherently profitable.

The second major point is that the financial industry, as you know, is changing dramatically and one of the difficulties in that change is the FIRREA legislation August of last year. The result is, Mr. Seidman told me 4 days ago that they have now reached $200 billion worth of real estate now that they are selling and the estimates are that that number could easily rise to $500 billion or a half a trillion dollars.

Part of the substantial overbuilding in markets was when we allowed thrift institutions and savings and loan institutions to actively involve themselves in the development process and in fact removed some of the discipline that's inherent between the developer and the lender because the lender crossed over that equation and they became one and the same. Where the lender is the pessimistic viewer of the project and the developer is the optimistic one, the two create balance and hopefully bring some wisdom to the process. When the lender becomes the developer, there's excess capital and less judgment, and in fact some of that is evidenced in misjudgment not only in the RTC properties but in the New England Bank and other New England property areas where you see substantial condominium overdevelopment and overbuilding.

Our concern is that the RTC is a major problem and that problem is being extended into our industry right now. There is new regulation as a result of the RTC bailout putting down stricter requirements on lending. Real estate is being reexamined and many customers and consumers are finding it more difficult to get credit in the real estate market.

Some of the changes to the loan-to-one-borrower rules as part of the FIRREA bill has ceased and stopped many development projects in process, bringing tremendous pressure on those developers that had a commitment to do the project and the commitment was pulled out from underneath them.

While we favor stricter underwriting and sound, reasonable regulation to ensure the integrity and quality of those institutions, we fear the over-reaction of some of the bailout activities that RTC and FIRREA bring to the table.

The third principle is that diversification and spreading of risks does not necessarily mean it lessens risk and in some instances it might even exacerbate the risk. I cite the Baldwin Corporation that attempted to get into the financial services activity and after a number of years finally nearing chapter XI spun out MGIC and other of its subsidiaries before it finally collapsed and went out of business.

The Sears' attempt to get into the financial services business has been an ill-fated one. Only recently they made a corporate decision to return to their basic core business and in fact attempt to sell some of their real estate holdings and in many instances found that there were no buyers out there to take them out.

It appears that if a core business is sick and weakening or dying, as is the case with Philip Morris, it makes some sense for them to get into businesses which will be viable. But if companies have viable business, it probably makes better business sense and a better business strategy if they stick to their knitting and do what they do best.

We would content to you that the financial institutions, the banking industry if you will, in this country has been an excellent source of credit, has been the major underpinnings of the economic growth and development of this country, and they ought to stick to their knitting. They ought to do what they do best because they are trained to do it and they understand that and they've done it and done it well and provided your guidance and direction and with the background that you've been able to give them.

In conclusion, we call for you in your deliberations of the three questions which relate to what new business should they be in, we think they should stay in the financial services business they are in and that they should not diversify for the sake of diversifying because in spreading they may be exacerbating the risk, that they may be getting into businesses that may look at the outset as being synergistic and highly potentially profitable, and in those major risk instances where they have been allowed to get in that has not been the case, and that you preserve the safety and soundness of those institutions so we have that good backdrop for the real estate consumer and the economy in general.

I will stand at the end of these hearings to answer whatever questions you might have.

[The complete prepared statement of Norman Flynn follows:]

EXECUTIVE SUMMARY
NATIONAL ASSOCIATION OF REALTORS®

During the last fifteen years, the financial services industry and its markets have undergone enormous change. This dynamic process has not taken place in a placid environment. driving and volatile economic forces have created increased financial strains on insured depository institutions and left the entire financial services system in a precarious position.

The U.S. Government is assigned responsibility for protecting the functioning and operations of financial institutions through the establishment of a tripartite federal safety net. That net consists of federal deposit insurance, a lender of last resort -- the Federal Reserve -- and an elaborate system of regulation.

The two most deleterious side effects of the current federal deposit insurance system are those involving the moral hazard to the U.S. Government, where bank managers and owners "bet the bank" and pass along adverse consequences of high risk decisions to the Government; and those involving the "too-big-to-fail" doctrine that has applied to large money-center banks and which implicitly insures their large uninsured domestic and foreign deposits.

NAR has not examined in detail or taken a formal policy position with regard to the various proposals being circulated to reform the federal deposit insurance system. NAR consider the issue at its annual meeting in November.

NAR's position regarding federal deposit insurance vis-a-vis its position regarding expanded activities of insured depository institutions has not changed. That is, there exists one federal insurance underwriter, the U.S. Government. While there may be symmetry between the federal and state-chartered institutions in terms of the amount of premiums assessed and the extent of coverage provided, there is complete asymmetry in terms of the actuarial risk to the deposit insurance system posed by the varying level of permissible activities.

NAR continues to oppose the authority of all insured depository institutions which benefit from federal deposit insurance, favorable tax treatment, and special access to credit (including their parents, subsidiaries, affiliates and divisions) to participate in real estate equity investment activities and real estate brokerage services, which are not directly related to their primary function.

Congress has attempted to provide proper regulatory oversight and supervision in conjunction with new authorities granted to insured depository institutions. However, regulatory supervision over depository institutions, particularly since 1982, has fallen far short of its goal of insulating insured deposits from certain non-traditional banking activities.

FIRREA does address, on a limited scale and in an incongruous fashion, the issue of financial institutions' involvement in real estate activities. For example, while it prohibits direct (i.e., through the institution itself) real estate or equity investments for state-chartered savings associations (and requires such activities to be conducted through separately capitalized subsidiaries), it does not prohibit so-called "agency" activities, such as real estate brokerage, where permitted by state law, to be conducted by the savings association itself.

Congress' efforts to address expanded powers being thwarted by regulatory and judicial usurpation of its policy-setting role. NAR believes the U.S. Court of Appeals decision in the so-called Merchants National regulatory action opens an enormous loophole in current law regulating the activities of bank holding companies. The Merchants National decision creates more than just a mere specter of new risk. It is a risk which cannot be eliminated through imposition of stringent capital standards or a revised system of deposit insurance.

In the case of real estate activities, generally we have seen a recognition of the fact that real estate activities do pose a risk to the financial services industry so much so that in the case of savings associations, investment and development activities are prohibited and brokerage permitted only where an institution meets the fully phased-in capital standards.

NAR has not examined in detail or taken a formal policy position with regard to proposals to merge the Office of Thrift Supervision into another regulatory agency such as the Office of the Comptroller of the Currency. In previous testimony, NAR has supported a separate thrift industry as the primary providers of a housing finance delivery system.

Real estate lending is a recognized traditional "banking" activity. The commercial banks are experiencing increased problems in their real estate portfolios. The OCC has found "fundamental deficiencies and negative trends in national bank real estate lending" and has increased the scrutiny of national commercial banks with significant real estate exposure and has required these institutions to write-down or write-off real estate loans in problem markets. Given banks' dismal performance in what has been characterized as a traditional banking activity in which they have long historical experience and developed skills and the resulting increased risk of exposure to the federal deposit insurance fund, why should they be permitted to engage in non-banking activities such as real estate investment, development and brokerage?

Proponents of deregulation have premised their pursuit of comprehensive restructuring on the upcoming implementation of the European Economic Community's (EEC) Economic Accord in 1992 (EC 92), at which time the EEC will be one economic entity for purposes of rules and regulations governing trade and commerce. NAR believes if previous other significant "deregulatory" events are any example of the future, the highly publicized potential effects of EC 92 may be just that and nothing more.

EC 92 and/or any potential modernization of the U.S. financial structure, cannot and will not, however, eliminate basic problems inherent in a bank and/or bank holding company structure which arise from the bank or bank holding company's involvement in non-banking activities. NAR does not believe that even the most stringent regulatory controls can eliminate potential conflicts with respect to control over or even restrictions placed by a financial institution on the supply of credit to competitors. They cannot eliminate a financial institution's monopoly power and ability to tie customers to non-bank products. Finally, they cannot prevent the dissemination of inside information from a financial institution to its affiliate.

STATEMENT OF THE

NATIONAL ASSOCIATION OF REALTORS®

BEFORE THE

UNITED STATES SENATE

COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS

APRIL 26, 1990

INTRODUCTION

Mr. Chairman, Members of the Committee, my name is Norman Flynn. I am a REALTOR® from Madison, Wisconsin and the 1990 President of the NATIONAL ASSOCIATION OF REALTORS®. On behalf of the more than 800,000 members of our Association, I want to thank you and the Members of this Committee for the opportunity to present our views on issues surrounding the future structure of the U.S. financial services industry and the federal deposit insurance system and what, if any, restructuring may be required.

OVERVIEW

During the last fifteen years, the financial services industry and its markets have undergone enormous change. Financial markets -- both nationally and globally -- have been linked together through geographic expansion of financial entities as well as new and dramatic technological developments in the payments system. A broad array of new financial products and services has been developed, particularly those associated with the process of securitization of lending.

This dynamic process has not taken place in a placid environment. Nor has it left the financial services industry unscathed. Rather, driving and volatile economic forces have created increased financial strains on insured depository institutions and left the entire financial services system in a precarious position.

The U.S. Government is assigned responsibility for protecting the functioning and operations of financial institutions through the establishment of a tripartite federal safety net. That net consists of federal deposit insurance, a lender of last resort -- the Federal Reserve -- and an elaborate system of regulation.

DEPOSIT INSURANCE REFORM

Federal deposit insurance today for depository institutions is provided by two government agencies. The Federal Deposit Insurance Corporation, through the Bank Insurance Fund, provides insurance for commercial banks, and through the Savings Associations Insurance Fund, provides insurance for savings associations. The National Credit Union Share Insurance Fund provides insurance for credit unions.

Prior to the enactment of FIRREA, the federal deposit insurance funds -- then existing in the form of the FSLIC, FDIC and NCUSIF, charged all federally-insured depository institutions the same premium as a proportion of total domestic deposits. Since FIRREA, renewed calls have been made to overhaul the federal deposit insurance system to instill market discipline in insured depository institutions' activities and to ensure that the risk incurred by these institutions is borne not by the U.S. Government but rather, by those who are in a position to be a source of market discipline for and to monitor the performance of the institutions.

As a general matter, we believe the two most deleterious side effects of the current system are those involving the moral hazard to the U.S. Government, where bank managers and owners "bet the bank" and pass along adverse consequences of high risk decisions to the Government; and those involving the "too-big-to-fail" doctrine that has applied to large money-center banks and which implicitly insures their large uninsured domestic and foreign deposits.

We understand that several proposals to reform the deposit insurance system have been proffered to date. They tend to fall in the following categories of approach:
(1) reduction of the current statutory ceiling for overall insurance coverage; (2) imposition of mandatory deductibles for coverage of deposits in excess of the current $100,000 limit; (3) limitations on activities financed by deposits to those of risk-free nature; (4) imposition of risk-based deposit insurance premiums based upon nature of the activities pursued; (5) redefinition of insurance of accounts to reflect coverage based upon the type of account and owner; and (6) limitations on coverage based upon the individual.

Mr. Chairman, the NATIONAL ASSOCIATION OF REALTORS® has not examined in detail or taken a formal policy position with regard to the various proposals being circulated to reform the federal deposit insurance system. As the 1990 President, however, I have appointed an internal working group from the association's two committees having responsibility for the development of association policy regarding financial institutions and the issue of federal deposit insurance. I have requested this group to consider and to make specific recommendations regarding proposals to reform the federal deposit insurance system and to bring such recommendations before the Association for its consideration at its annual meeting in November.

Despite this, Mr. Chairman, I would note that our position regarding federal deposit insurance vis-a-vis our position regarding expanded activities of insured depository institutions has not changed. That is, there exists one federal insurance underwriter, the U.S. Government. While there may be symmetry between the federal and state-chartered institutions in terms of the amount of premiums assessed and the extent of coverage provided, there is complete asymmetry in terms of the actuarial risk to the deposit insurance system posed by the varying level of permissible activities. One has only to review the savings and loan association/FSLIC debacle to see the obvious: while approximately the same number of Federal-chartered and state-chartered savings associations have been declared insolvent, the cost to the deposit insurance funds to resolve the state-chartered institutions has been twice as much as their Federal counterparts.

The NATIONAL ASSOCIATION OF REALTORS® continues to oppose the authority of all insured depository institutions which benefit from federal deposit insurance, favorable tax treatment, and special access to credit (including their parents, subsidiaries, affiliates and divisions) to participate in real estate equity investment activities and real estate brokerage services, which are not directly related to their primary function.

CURRENT REGULATORY STRUCTURE

Mr. Chairman, this Committee and the Congress have attempted to provide proper regulatory oversight and supervision in conjunction with new authorities granted to insured depository institutions. Despite the best of intentions and carefully crafted safeguards, however, regulatory supervision over depository institutions, particularly since 1982, has fallen far short of its goal of insulating insured deposits from certain non-traditional banking activities. This was particularly notable in the case of savings associations and the state initiatives to expand activities in the years following enactment of the Garn-St Germain Depository Institutions Act. With the ensuing S&L/FSLIC crisis and enactment first, of the Competitive Equality Banking Act in 1987, and the Financial Institutions Reform, Recovery and Enforcement Act of 1989, we believed that recognition of the problems were out in the open.

We believe that FIRREA has proven to be an incongruous piece of legislation, particularly regarding its current and potential impact on financial services restructuring. It was originally touted as putting the kibosh on the deregulation trend of the 1980s; FIRREA does address, on a limited scale and in an incongruous fashion, the issue of financial institutions' involvement in real estate activities. For example, while it prohibits direct (i.e., through the institution itself) real estate or equity investments for state-chartered savings associations (and requires such activities to be conducted through separately capitalized subsidiaries), it does not prohibit so-called "agency" activities, such as real estate brokerage, where permitted by state law, to be conducted by the savings association itself.

FIRREA has the capacity to strengthen the entire financial services system, particularly when the activities provisions are viewed in conjunction with the Act's required implementation of stringent new capital standards. Capital standards, as we are all too painfully aware, were progressively and entirely debased in the early years of the 1980s. This condition was exacerbated, if not rendered entirely meaningless, by the regulatory agencies' policy of regulatory forbearance.

We certainly would concur with the concept that institutions which operate on the basis of strong capital standards came through the deregulatory era in relatively good health, in sharp contrast to institutions that risked little or no capital of their own. However, we are extremely doubtful whether marketplace discipline and competitive equality can be restored and maintained through strengthened capital standards alone or even in conjunction with reform of the federal deposit insurance system.

Unfortunately, while Congress has attempted to move to address the issues of expanded powers, it efforts are constantly being thwarted by regulatory and judicial usurpation of its policy-setting role. The NATIONAL ASSOCIATION OF REALTORS® believes that the decision of the U.S. Court of Appeals for the Second Circuit in the so-called Merchants National regulatory action opens an enormous loophole in current law regulating the activities of bank holding companies. More importantly, it jeopardizes the foundation upon which our entire financial services structure was built, that is, the risk of financial and economic concentration brought about by the wholesale merger of financial and commercial enterprises. The Merchants National decision creates more than just a mere specter of new risk. Indeed, it is a risk which cannot be eliminated through imposition of stringent capital standards or a revised system of deposit insurance.

In the case of real estate activities, generally we have seen a recognition of the fact that real estate activities do pose a risk to the financial services industry so much so that in the case of savings associations, investment and development activities are prohibited and brokerage permitted only where an institution meets the fully phased-in capital standards.

We believe that given the dismal performance of the thrift industry in its involvement in real estate activities, FIRREA did not go far enough to limit the real estate activities of savings associations.

Finally, we would like to respond to your request for comments concerning proposals to merge the Office of Thrift Supervision into another agency, such as the Office of the Comptroller of the Currency. The NATIONAL ASSOCIATION OF REALTORS® currently has not examined in detail or taken a formal policy position with regard to this issue; We have, however, consistently supported the concept of a specialized cadre of financial institutions to serve as this nation's housing finance delivery system. To that end, in testimony last year before this Committee regarding FIRREA, the Association expressed its support for a separate thrift industry. We also noted our concern regarding the potential loss of an independent Federal Home Loan Bank System and its Board which would result from the Administration's proposal.

We recognize that the economic environment has changed for the thrift industry following enactment of FIRREA and further, that those within the industry are calling for a consolidation of functions. Given the changes which have ensued, I will have the appropriate committees within the Association review this issue and recommend a formal policy position at the Association's annual meeting in November.

BANK PERFORMANCE IN REAL ESTATE LENDING UNDERMINES EXPANDED POWERS PROPOSALS

We would commend to the Committee's attention the current performance of commercial banks in real estate lending activities. Real estate lending, Mr. Chairman, is a recognized traditional "banking" activity. Yet, the newspapers are replete with countless tales of commercial banks' mounting real estate woes, emanating first in New England, but spreading rapidly down the East Coast and throughout the remainder of the United States. Indeed, the Office of the Comptroller of the Currency (OCC), in an advisory issued last month to bank officers, said examiners had found "fundamental deficiencies and negative trends in national bank real estate lending" and that "examiners have been instructed to recommend enforcement action as appropriate."

Since 1987, the OCC has acknowledged that real estate values are subject to cyclical swings. Suffice it to say, some of the nation's real estate markets have softened considerably since the halcyon years of the mid-1980s. Experts, including the large money-center banks Citicorp and Chase Manhattan, are predicting continued softness in many markets in the years to come. In the meantime, the real estate portfolios of commercial banks in the affected areas are not turning out to be the cash cows as originally hoped for or projected.

Having learned an important lesson in the Southwest on the need for preventive action, the OCC has increased the scrutiny of national commercial banks with significant real estate exposure and has required these institutions to write-down or write-off real estate loans in problem markets. Mr. Chairman, our point here is not to debate whether poor commercial real estate markets or more stringent regulatory standards have led to increase write-offs in recent months and a concomitant deterioration of the earnings positions of those banks involved. Rather, we want to emphasize that given banks' dismal performance in what has been characterized as a traditional banking activity in which they have long historical experience and developed skills and the resulting increased risk of exposure to the federal deposit insurance fund, how, in all good conscience and on a rational basis, can we proceed to authorize banks to engage in non-banking activities such as real estate investment, development and brokerage?

EC '92 -- IMPLICATIONS FOR U.S. FINANCIAL INSTITUTIONS; INHERENT STRUCTURAL PROBLEMS

Mr. Chairman, proponents of deregulation have premised their pursuit of comprehensive restructuring on the upcoming implementation of the European Economic Community's (EEC) Economic Accord in 1992 (EC 92), at which time the EEC will be one economic entity for purposes of rules and regulations governing trade and commerce. As part of the EC92 Accord, the EEC is scheduled to implement a common banking system by means of a European banking license. This single European banking license would authorize a bank to engage in a broad range of financial services/activities through branches in the EEC subject to regulation and supervision only by authorities in the bank's "home" Member State.

At first blush, the proponents' of deregulation arguments appear quite valid. They cite the need for deregulation because of the competitive pressures being brought to bear on our financial institutions with the advent of one European super banking structure. We believe, however, that if previous other significant "deregulatory" events are any example of the future, the highly publicized potential effects of EC 92 may be just that and nothing more. The "Big Bang" in the United Kingdom and the subsequent "Baby Bang" in Canada started out with much fanfare. In a short period of time, they became non-events and many U.S. banks which had set up branches abroad, subsequently closed or substantially scaled back their operations.

More significantly EC 92 and/or any potential modernization of the U.S. financial structure, cannot and will not, however, eliminate basic problems inherent in a bank and/or bank holding company structure which arise from the bank or bank holding company's involvement in non-banking activities. We do not believe that even the most stringent regulatory controls can eliminate potential conflicts with respect to control over or even restrictions placed by a financial institution on the supply of credit to competitors. They cannot eliminate a financial institution's monopoly power and ability to tie customers to non-bank products. Finally, they cannot prevent the dissemination of inside information from a financial institution to its affiliate.

CONCLUSION

Mr. Chairman, the American taxpayer is getting stuck with the staggering cost of bailing out the thrift industry. Warning flags are being raised about mounting troubles among the nation's banks. The banking system is under enormous strain. Standing in the shadow of the ruination of the thrift industry, we do not believe that expanded powers for banks will solve any of their problems.

The **Chairman**. Very good. Thank you for your statement.

Mr. Friedman, we'd like to hear from you now.

STATEMENT OF STEPHEN J. FRIEDMAN, EXECUTIVE VICE PRESIDENT AND GENERAL COUNSEL, THE EQUITABLE LIFE ASSURANCE SOCIETY OF THE UNITED STATES; REPRESENTING THE AMERICAN COUNCIL OF LIFE INSURANCE AND OTHER REPRESENTATIVES OF THE INSURANCE INDUSTRY

Mr. **Friedman**. Thank you, Mr. Chairman. It's a pleasure to appear again before this distinguished committee.

I'd like to cover three matters this morning. First, our review of the current stage of bank deregulation; second, some comments on the Merchants National case and its significance; and third, the anomaly of pass-through deposit insurance for BIC's and its significance for the deposit insurance system.

I think that it's foolish to debate whether or not there ought to be bank deregulation. As you pointed out, Mr. Chairman, there has in fact been an extraordinary amount of deregulation in the 10 years or so that have just elapsed. We've seen deregulation of interest rates. Banks have obtained virtually full securities powers without any action by the Congress. They have obtained the power to engage in credit insurance. We have made huge steps toward interstate banking. Massive new competitors have appeared on the scene: money market funds on the liability side and the commercial paper market, and foreign banks on the asset side.

We also have been witness to a series of lending excesses during the past 10 years. LDC loans, oil patch lending, more recently some unwise LBO loans, real estate lending in the Northeast. Every observer of the banking system agrees that the level of risk is substantially higher today than it was 10 or 15 years ago. There is no dissent on that.

The question seems to me is whether we have adequately digested the lessons of the last decade. Can the Congress or the bank regulators really say that they understand which of the changes that have occurred have been beneficial and which detrimental to bank stability? Do we really understand, for example, the significance of the fact that the most profitable banks in the United States are the regionals and the super-regionals which—are the most plain vanilla kinds of banks we have?

We all know that the answer to each of those questions is "no". In the matter of financial services deregulation, we have all been like the fleas that cling to the back of the dog, and think that they are driving. We have been riding and riding a very difficult wave.

I hope for the sake of the American economy that these changes have been beneficial, but one thing is very clear. That is, that we must understand the effect of the changes that have occurred before substantial new risks are introduced into the banking system.

Now if the life insurance industry represents, as I believe it does, the safest of financial intermediaries in general, why does it introduce serious risks into the banking system? That is true it seems to me because it is a very different business with an entirely different kind of liability structure and an entirely different asset structure.

Both are financial intermediaries. But their businesses are substantially different.

It is not that these risks cannot be conservatively managed. Every risk can be conservatively managed. But it takes an entirely different set of skills and an entirely different set of investment outlooks.

I don't think it helps to say "let's put those risks in a separate subsidiary." It is very clear that both banking and life insurance are confidence businesses. Without the full confidence of their customers, individuals and institutional customers, those businesses can evaporate very, very quickly. And crises of confidence are not contained by nice legal theories about the difficulty of piercing the corporate veil.

The recent experience of Drexel Burnham and, more significantly I think, the mess with Baldwin United, reflect the difficulty of trying to hold together a diversified financial services company when one part of it starts to unravel.

I also don't think we should be rushed into imprudent action because of events in the European Community. The arguments from the European Community really have three aspects: size, powers, and the danger of discrimination against American banks.

The size question is a conundrum. Every study that's ever been made of the efficiencies of scale in banking has concluded that efficiencies of scale stop well short of the current size of American banks. The Federal Reserve Board has cautioned that it's a mistake to confuse competitiveness with size. Certainly the most profitable American banks, even the most profitable money center and international banks, are not the largest.

Powers are quite a different question. I really fail to see why having insurance powers or real estate powers, for that matter, in the United States makes an American bank more competitive in Europe.

Discrimination is the third issue. I think that as long as European banks are afforded national treatment in this country it is highly unlikely that the European Community is going to discriminate against American banks in Europe. Even if we feared that were the case, however, it's important to keep in mind that what we're talking about here is safety and soundness. The stability of our banking system is of primary concern to this Congress, to our bank regulators, and to our economy. Those judgments ought not to be traded off in trade negotiations with the Europeans.

Let me turn now to Merchants National. As this committee knows, the Congress in general has not acted on most of the issues that the bank deregulation has presented, particularly in the Glass-Steagall area.

One of the few areas in which Congress has spoken contemporaneously and clearly is in life insurance. The national banks have long been prohibited from underwriting life insurance. In 1982, the Bank Holding Company Act was amended to prohibit underwriting and most sales to bankholding company subsidiaries.

No one in their wildest dreams had any idea that States would authorize banks to underwrite life insurance at the time and now the States, in what I think can only be described as a cynical drive to increase their local tax bases, are considering authorizing a new kind of animal—banks-that-underwrite-and-sell-life-insurance. It is the Federal deposit umbrella that protects the citizens of those States from the consequences of that action, actions which are motivated not by bank regulatory reasons but by the desire to increase the local tax base.

This legislation is under consideration now in 12 States. It is one vote away from passage in Delaware. It is an incredible irony that while this committee is engaged in an extraordinary debate about whether the bank holding company structure and firewalls are sufficient to insulate banks from the additional risks of nonbanking activities in subsidiaries, we are about to sanction a step which would put a significant nonbanking activity in the bank itself or in the bank's operating subsidiary. That is the worst possible result—the worst possible way to do it, and it would represent a complete surrender by the Congress of its authority to set banking policy for this nation.

Let me conclude with just a word about BIC's. That, too, is an extraordinary debate in the context of what's going on now. What everyone is worrying about today is the extent to which the deposit insurance system increases the risk in the banking system. The effect of pass-through insurance is to extend deposit insurance to large institutional investors, institutional investors which, for example, aren't deemed to require the protection of large portions of the securities laws. No one believes that large investors should be protected by deposit insurance, but that's the effect of what's going on.

Mr. Chairman, that concludes my oral statement. I would be happy to answer questions.

The **Chairman**. When we get to the questions, I want you to elaborate on that last point.

Mr. **Friedman**. I would be happy to.

[The complete prepared statement of Stephen J. Friedman follows:]

STATEMENT OF THE AMERICAN COUNCIL OF LIFE INSURANCE

Before the

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

of the

UNITED STATES SENATE

on

MODERNIZING THE REGULATION OF FINANCIAL SERVICES

April 26, 1990

Statement Made By:

Stephen J. Friedman
Executive Vice President
and General Counsel
The Equitable Life Assurance
Society of the United States

Mr. Chairman and members of the Committee, my name is Stephen J. Friedman. I am the Executive Vice President and General Counsel of The Equitable Life Assurance Society of the United States. I am appearing today on behalf of the American Council of Life Insurance. The Council is the principal trade association for domestic life insurance companies. Its 616 members account for approximately 94% of the life insurance in force in the United States and over 98% of the privately insured pension business.

The Council appreciates the opportunity to provide you with its views on the regulation of financial services in this country. My remarks today are directed at two specific aspects of this broad issue. The first involves the risks to the banking system that will arise if banks are given expanded insurance powers. Here, we are dealing not only with the question of whether Congress should afford banks broader insurance powers but also with the problems that result when states and federal bank regulatory agencies preempt the role of Congress in establishing national banking policy. The second involves our belief that aspects of the federal deposit insurance system are in need of immediate reform regardless of whether Congress grants banks additional nonbanking powers. Specifically, we believe Congress should act to eliminate excessive "pass-through" deposit insurance for bank participation in certain sophisticated pension investment activities.

EXPANDING BANK INSURANCE POWERS

Overview

There has not been any fundamental change in the position of the life insurance industry on financial services restructuring since we last appeared before this Committee in 1988. We continue to believe that the public is best served by maintaining the historic separation between banking and commerce.

We do not intend to restate all of our traditional arguments against bank entry into insurance and other forms of commerce. The members of the Committee are as well versed on these points as anyone in the financial services community. However, it would seem worthwhile to comment on a number of developments in the marketplace, as well as selected statements recently offered by bankers in support of their quest for new powers.

Recent Events Argue Against Deregulation

It has been stated by some that further banking deregulation is an issue whose time has come and that it is inevitable given prevailing marketplace forces. The American banking system has experienced a cataclysmic series of changes over the past decade. There has been an enormous expansion of asset and liability powers, and interstate banking is virtually upon us. What is required is a period of digestion and appraisal before additional changes are seriously entertained. Let me list just a few of the changes in banking during the late 1970s and the 1980s:

- interest-bearing checking accounts (NOW Accounts)
- deregulation of interest-rates (Reg Q)
- LDC lending
- oil-patch lending
- real-estate construction lending
- development of massive new competitors
    - money-market funds on the liability side
    - the commercial paper market and foreign banks on the asset side
- virtually full securities powers
- financial guarantee insurance
- substantially increased risk in the banking system because of higher costs of capital and a loss of the best credits to the commercial paper market
- interstate banking through interstate compacts and cross-border ownership of S&Ls

Are the returns now in on the effects of these great changes and higher risks? Can this Committee make an intelligent judgment about the lessons we have gleaned from these experiences? Have we improved our understanding of what kinds of powers improve the quality of our banking system and what kinds do not?

If the answers to these questions are "no" -- and I am confident that they are "no," then is this the time to introduce wholly new risks into the banking system? For, as my testimony will show, that would plainly be the effect of granting bank holding companies the power to underwrite life or casualty insurance.

Over the last four years, in addition to the collapse of thrift industry, more than 700 banks have failed. Did these failures occur because banks were unable to break into the insurance or real estate businesses? Hardly. More often than not, they were a result of mismanagement, fraud, or poor regulatory supervision. A recent article in the American Banker noted that the FBI has more pending cases of fraud and misappropriation of funds involving failed banks (276) than it does involving failed thrifts (234) -- a real surprise considering all the press the thrift cases are receiving. Moreover, it is clear that one of the principal bank regulators, the FDIC, is over extended trying to work its way through the debris of the thrift industry. Indeed, this very concern was expressed by consumer groups testifying before this Committee just last week.

For all these reasons we find it difficult to understand how serious consideration would be given at this time to bestowing new insurance powers on banks. It is painfully evident that bank regulators are having difficulty handling banking's current complement of powers. It is simply unreasonable to suggest that the solution for the competitive pressures on banks is to give their managers more businesses to oversee, businesses that import an entirely new and unfamiliar set of risks.

Risk and Risk Management

We are not suggesting that the insurance business is more risky than the banking business. But, each business has its unique set of risks, those risks are substantial, particularly for the inexperienced, and they are quite different in the two industries. Our point is that the combination of banking and insurance would result in the aggregation of these risks, and, in turn, jeopardize the safety and soundness of the banking system.

Let me elaborate for a moment. The principal liabilities of banks are consumer deposits (which are insured by the FDIC), CDs and funds purchased in global money markets. The average maturity of those liabilities tends to be relatively short, the principal determinants are financial and the banking system has the safety net of the Federal Reserve discount window. Like a bank, a life insurance company is a financial intermediary. However, its liabilities are life insurance policies, annuities and special instruments like GICs -- which are discussed at some length below. The maturity of those liabilities is determined by actuarial experience, by major currents in national health (such as AIDS), by financial factors (especially in the case of annuities) and by a unique range of options that have been given historically to customers. (See the discussion of GICs below). These difference in liabilities involve the management of a wholly different set of risks than those in banking and require a wholly different set of investment policies on the asset side.

Everyone appreciates that the banking business is highly competitive and that making a profit is no longer a foregone conclusion. But each financial service industry is faced with the same challenges. Many bankers believe that a solution to their problems is to be able to enter other businesses such as securities, insurance and real estate. Unfortunately, expanded powers have not proved to be a sure-fire solution. Profits in these nonbanking businesses can be very elusive. Banks have fought hard to gain securities powers, and they have been very successful in obtaining these powers. But the securities business has not proved to be a pot of gold -- or even very profitable in recent years. The fact is, if a bank is not successful as a bank, it is difficult to imagine how it will suddenly find success in managing a laundry list of unfamiliar businesses, each posing substantial risks that are both different and unfamiliar.

The Inadequacy of Firewalls

It continues to be suggested that banks can be insulated from their non-banking operations with adequate firewalls. While that may be true in a technical, legal sense, marketplace conduct has demonstrated again and again that the failure of one part of a financial institution is perceived in the public mind as simply one localized symptom of a widespread and fatal disease. Federal Reserve Board Chairman Alan Greenspan noted this phenomenon recently when commenting on the collapse of several otherwise healthy Drexel Burnham subsidiaries when the Drexel junk bond operation slid under water. "This experience raises a number of questions about the separation of activities in financial holding companies and about the possible need for an overview of the entire holding company, both regulated and non-regulated entities," he said. The experience of Baldwin-United in the insurance arena demonstrated the impact of failed insurance subsidiaries on the rest of the holding company operations.

Firewalls look good on paper and work well in times of economic stability and prosperity. But, we have seen time and again that firewalls -- no matter how thoughtfully erected -- are easily and quickly breached when adversity is experienced.

Troubled corporations are unquestionably aware of the ramifications of letting a subsidiary fail. That is why Continental Illinois chose to violate the law and lend bank funds to its troubled First Options subsidiary some time ago rather than let the subsidiary fall into violation of its capital requirements. Although it's not new, the comment of former Citicorp Chairman Walter Wriston remains as the most authoritative explanation of the inherent inadequacies of firewalls. He stated:

> "It is inconceivable that any major bank would walk away from any subsidiary of its holding company. If your name is on the door, all your capital funds are going to be behind it in the real world. Lawyers can say you have separation but the marketplace is persuasive, and would not see it that way."

Bank Insurance "Experience"

In recent testimony before the Financial Institutions Subcommittee of the House Committee on Banking, Finance and Urban Affairs, Alan Tubbs, the incoming president of the American Bankers Association, revived the time-worn suggestion of the banking industry that their limited involvement with savings bank life insurance and their activities in the credit life area provide them with "experience" in the underwriting of life insurance. The fact of the matter is that neither credit life nor savings bank life provide banks with any meaningful experience with actual insurance underwriting.

While many banks make credit insurance available to their customers, only a very small percentage actually act as principal and "manufacture" the product themselves. Most banks simply arrange for the purchase of credit life insurance through an unaffiliated life insurance company.

Because of the nature of the product, those banks that do manufacture credit life insurance are not really engaged in insurance "underwriting". Credit life is a form of term insurance with a decreasing face amount. In virtually all states, the face amount may not exceed the amount of the outstanding loan. Over 90% of the credit life insurance in force is written under group contracts, and the amounts written are relatively small and the duration of coverage relatively short. The participants are selected because they are borrowers, not as a result of a life insurance underwriting process. Consequently, there is total absence of actual "underwriting" or risk selection. Finally, the bank itself is the policy beneficiary, thus eliminating virtually all risk as underwriter.

Similarly, SBLI, which is sold only in Massachusetts, Connecticut and New York, does not provide banks -- even those savings banks that "underwrite" the product -- with any significant life insurance underwriting experience. SBLI enjoys an anomalous form of regulation pursuant to which participating savings banks are in fact prohibited from involving themselves in anything but insurance agency activity. It is the separate SBLI industry-wide "fund" and not the management of the participating banks that has any familiarity with insurance operations. The "fund" performs two basic functions for all participating savings banks. First, it provides a single pool of mortality risks, and second it establishes uniform standards and practices for all insurance aspects of the business.

Virtually the only thing left for a participating savings bank to do on its own is to determine how to invest the funds held by its "insurance department", and then it may do so only consistently with the investment limitations applicable to the bank itself. In sum, the SBLI regulatory system eliminates the need of a participating savings bank to worry about risk selection, product pricing, policy forms, actuarial expertise, mortality experience, or insurance accounting. Any insurance risks assumed by a participating savings bank are in turn guaranteed by the fund.

EC 1992 Does Not Necessitate New Powers For Banks.

The anticipated consolidation of European Common Market economies in 1992 is being increasingly cited as an argument for granting expanded financial service powers to U.S. banks. In their home markets, European banks have generally been permitted to engage in a wide range of financial services, including insurance and securities. U.S. banks are now asserting that they need more powers in the U.S. market to remain competitive in the international marketplace and that they will have a declining influence unless they can increase their size relative to European and Japanese banks. Before discarding in a rush of concern about EC 1992 our inherited wisdom about the benefits of a separation of banking and nonbanking activities for our domestic economy, Congress should take a long, hard look at these assertions.

Regulation of U.S. banks has long recognized that limitations on banking powers appropriate in the U.S. market may not be suitable when U.S. banks compete in foreign countries. U.S. banks can already engage in insurance and and securities activities abroad. Consequently, in Europe they are currently on an equal footing with the European banks and would continue to be so following the consolidation assuming the adoption of a "national treatment" standard. And, assuming a continuation of current U.S. law, all banks operating in the U.S., both foreign and domestic, will be subject to equivalent constraints on their nonbanking activities. We do not believe that this state of affairs will prompt the EC to impose additional discriminatory conditions on U.S. banks operating abroad. As the highly regarded "Group of Thirty" conclude: "The basic approach will be reciprocal national treatment.... Given that national treatment is widely used as the basis for judging acceptable reciprocity, and given that most major international banks already operate in the EC, these are important assurances for non-member institutions." Even if that were not the case, however, we should not discard our system separating banking from commerce just to appease the Europeans. Issues of the safety and soundness of American banks are of primary concern to the U.S. economy, and we should not sacrifice the stability of our banking system in trade negotiations with the Europeans.

One should not lose sight of the fact that the "we need more powers to compete" notion is exactly the same argument that the thrift industry advanced in the early 1980s. Thrifts argued that only with these new powers could they be profitable and compete effectively with banks. Congress provided them with those new powers. The thrifts took them and produced the largest financial disaster in the history of the United States. If we have learned anything from the savings and loan mess it is that allowing insured institutions into risky and unfamiliar businesses has no guarantee of success.

We can, without resort to unfair comparisons, draw certain parallels to the origins of the thrift crisis. Because of inflation and skyrocketing interest rates in the 1970s and early 1980s, Congress and the states were persuaded to give thrift institutions broader asset and liability powers. The original purpose of the changes in asset (investment) powers grew out of the fact that savings institutions borrowed short (deposits) and lent long (fixed-rate mortgages). When short-term rates rose sharply, the thrifts' cost of funds rose, but the earnings on their mortgages remained constant. Commercial loans were originally intended as a source of more interest-sensitive investments for the thrifts, but that original purpose became lost in the drive for "deregulation" and expanded powers.

So with banks. There has been tremendous change in the past decade. The banking system has more risk than in past years. If banks are to be given more powers, it should be because those powers would serve a specific purpose in the context of profitability and risk management in a modern bank -- not simply because the banks of some other countries have those powers or because it might be a way to make some money.

Finally, bank assertions about inadequate size to compete internationally are not well founded. As Federal Reserve Board Chairman Greenspan explained in recent testimony before the House Task Force on the International Competitiveness of U.S. Financial Institutions, measures of size can be "very misleading" as measures of international competitiveness and influence. In particular he noted that "there is no evidence in the professional literature that the size of an internationally active bank by itself has a significant bearing on a bank's costs or efficiency" and "that cost controls and differences in management across banks of the same size are more relevant for competitiveness than any economies of super-scale are likely to be." To the extent that size has a bearing on costs or efficiencies, anticipated consolidations in the banking industry in this country during the 1990s can be expected to result in dramatically larger U.S. banks by the turn of the century.

The Merchants National Decision

The recent Merchants' National decision is an important component of any discussion on financial services restructuring.

Merchants National refers to a decision rendered last November by the Court of Appeals for the Second Circuit in Independent Insurance Agents of America, et al. v. Board of Governors of the Federal Reserve System. The case involved a challenge to a Federal Reserve Board ("Fed") order permitting Merchants National Corporation, a bank holding company, to sell property/casualty insurance through two of its Indiana-chartered bank subsidiaries. In both instances, the insurance sales activities were conducted directly within the banks themselves and not through nonbank subsidiaries. The Fed's order, which was upheld by the Court, reflected the view that the nonbanking prohibitions of Section 4 of the Bank Holding Company Act do not apply to activities conducted directly by a bank subsidiary of a bank holding company. Legislation is pending in 12 states to authorize state banks to sell or underwrite insurance. Proponents of this legislation fully intend to take advantage of the Merchants National decision if these powers are granted.

The legal and practical ramifications of the decision reach far beyond the business of insurance. Perhaps the most serious misconception of Merchants National is that it merely involves an authorization for holding company state banks to sell property/casualty insurance. Nothing could be further from the truth. The "loophole" that the decision legitimizes virtually emasculates the nonbanking limitations Congress imposed on bank holding company systems through Section 4 of the BHCA. While the facts in Merchants National dealt with insurance sales, the resulting legal principle extends to any nonbanking activity authorized for state banks that are in holding company form. In effect, the power to amend the BHCA has been given to the states.

A fundamental purpose of the BHCA is to prevent the conduct of banking and other forms of commerce within the same entity. Section 4 of the BHCA is the principal provision effectuating this separation and contains general limitations on the conduct of nonbanking activities. In 1982, Congress strengthened those limitations as they apply to insurance by adding a basic prohibition on the sale and underwriting of insurance by bank holding companies.

The irony of the Merchants National decision is apparent. Activities which the BHCA declares unsuitable for conduct in an affiliate of a bank, because of the threat they present to the safety and soundness of the bank, can now be conducted directly in the bank itself. This result despite the fact that the prevailing regulatory view is that the conduct of nonbanking activi- in an affiliate is safer than the conduct of those activi- in the bank itself. Accordingly, if left standing by Con- ss, the Merchants National decision could have serious consequences for the safety and soundness of banking.

Forces operating at the state level appear to be causing state legislatures to depart from the traditional wisdom of confining commercial banking powers. Instead, states, with increased impetus from the Merchants National decision, are acting to expand the authority of banks to enter other financial and business areas. Important among these forces are the economic incentives offered to the states by large banks. For example, Delaware, which is the host to some 40 bank subsidiaries owned by out-of-state companies, including most of the large New York banking companies, remains one vote short of passing legislation which would allow these banks to operate as full service insurance companies throughout the country. The Delaware bill expressly allows banks to conduct insurance underwriting directly.

Similarly, South Dakota, which has benefited from the presence of a large credit card bank owned by Citicorp, enacted legislation in 1983 authorizing the acquisition by out-of-state bank holding companies of South Dakota banks which would have the direct authority to underwrite insurance in all states of the union except South Dakota. Pursuant to this legislation, Citicorp attempted to acquire a South Dakota bank for the purpose of underwriting insurance. Since the bank would engage only in insignificant banking activities, the Fed was able to preclude this acquisition as an obvious scheme to circumvent the BHCA. It is worth noting, however, that the court in Merchants National raised a question about whether the Fed had the authority under the BHCA to stop even a scheme so egregious as the one in South Dakota.

Significantly, the Federal Reserve Board has expressed grave concerns over permitting holding company banks to underwrite insurance directly. Testifying earlier this month before a subcommittee of the House Banking Committee, Federal Reserve Board Vice Chairman Manuel Johnston stated that "we certainly don't feel that insurance underwriting is a safe activity to be conducted directly by a bank .... Our view is that insurance underwriting has potential losses and risks associated with it that we do not want to expose the federal taxpayer to."

For most of this country's history, state legislatures have had reason to be cautious about the powers granted to their banks. Banking for the most part has been a local activity and the failure of a bank had severe consequences for the residents of a state. However, the 1980 increase in federal deposit insurance coverage to $100,000 has reduced the pressure on the state legislatures. Because of this high level of insurance, very few individual residents of a state are likely to suffer direct loss from a bank failure. States therefore have more leeway to experiment. The financial consequences of unsuccessful experimentation will be left for payment by the federal taxpayer.

Some might claim that federal legislation which would directly affect the powers of state-chartered banks is an abrogation of the dual banking system, which is considered a cornerstone of banking in the United States. There are a number of answers to such contentions. Congress has previously acted to restrict the powers of state banks when in 1933 it prohibited depository institutions from underwriting securities. The actions taken by South Dakota and Delaware appear designed not to meet the needs of residents of those states, but rather to allow out-of-state banking companies to obtain powers to be exercised primarily outside of those states. The structuring of banking services in interstate commerce is the prerogative of Congress, not any single state legislature. Finally, the risk of bank failure has, through federal deposit insurance, been substantially shifted from residents of a particular state to the federal taxpayer. Taxpayers are already saddled with a tab recently estimated by the General Accounting Office to be in excess of $300 billion to bail out the thrift industry. The responsibility of Congress to protect taxpayers against future losses from the federal deposit insurance system is evident.

You should also not be lulled into believing that the loophole created by the Merchants National decision can be fixed by action of the federal bank regulators. This is not a problem appropriate for regulatory solution. Regulatory action is significantly influenced by the individual philosophies of the senior administrators at any point in time. While it is a proper function of regulators to interpret rules established by a legislative body, it is not their proper function to establish the basic rules themselves. Establishing rules governing bank powers requires not only determinations about safety and soundness, but also about the competing interests of different business constituencies. The confines of the powers to be exercised by federally insured banks in interstate commerce is a fundamental rule which is proper only for Congress to decide.

Moreover, there is a substantial question as to whether any of the federal bank regulators has a real ability to address the Merchants National problem. The Comptroller has no authority over state banks. The Fed's authority over state member banks can easily be circumvented by housing the nonbanking activities in a state nonmember bank. True, the FDIC is authorized to consider when acting on an application for deposit insurance whether the corporate powers of a state nonmember bank are consistent with the Federal Deposit Insurance Act. However, terminating the coverage of a bank which already has deposit insurance by reason of its exercising powers granted by its chartering authority appears to require a cumbersome case by case process with ample opportunity for hearing and judicial review.

Even if rulemaking could simplify the process of terminating a bank's deposit insurance, the FDIC's recent involvement in this area evidences a lack of effectiveness. Recognizing the risk to safety and soundness from bank participation in insurance and real estate activities, the FDIC in 1983 initiated a rulemaking process pursuant to which a rule was proposed requiring such activities to be conducted in a separately capitalized subsidiary walled off from the bank itself. More than four years later, the proposed rule was withdrawn, and no final action was taken.

DEPOSIT INSURANCE REFORM

The Council believes that whether or not banks are granted broader nonbanking authority, the deposit insurance system is already in need of reform. Rightly or wrongly, the bank regulatory agencies have dramatically broadened the scope of permissible bank insurance and securities powers. As a result, the insurance funds -- and taxpayers -- are being exposed to liabilities never intended by Congress when the insurance system was established. The harmful consequences of an overbroad deposit insurance system are being driven home on an almost daily basis as Congress and the financial services industry grapple with the multi-billion dollar bailout of the thrift industry.

The Council takes no position on how the deposit insurance system might be reformed in a broad sense. We do, however, have strong views on how one aspect of that system -- "pass-through" insurance coverage for some bank obligations used to fund large pension plans -- should be curbed. The balance of our statement addresses this issue.

Pass-Through Deposit Insurance for Bank Investment Contracts

During consideration of the Financial Institutions Reform, Recovery and Enforcement Act of 1989 ("FIRREA"), concerns were voiced regarding a decision by the FDIC to extend deposit insurance on a pass-through basis to so-called bank investment contracts or "BICs." As a result of those concerns, language was included in FIRREA requiring the FDIC, the General Accounting Office and the Treasury Department to prepare reports on the issue. The FDIC has submitted its report and it will be discussed later in this statement. GAO and Treasury have not yet completed their studies.

As a result of its decision to permit BICs to enjoy deposit insurance on a pass-through basis, the FDIC has extended deposit insurance into an area where such coverage is neither necessary nor appropriate. This action has dramatically and needlessly expanded the liabilities of the insurance funds and has placed life insurance companies at what ultimately may be an insurmountable competitive disadvantage.

Background

BICs are directly patterned after guaranteed investment contracts or "GICs," a product that insurance companies have sold to employee benefit plans for years. Indeed, with the exception of the deposit insurance feature, BICs replicate GICs in all material respects. Both BICs and GICs are sold today primarily in the defined contribution plan market, and have become quite popular with the advent of Section 401(k) plans.

Both BICs and GICs are written with a variety of features and maturities, but the most typical contract is a 2-6 year obligation guaranteeing both a fixed rate of interest on the amount deposited and the rate of interest earned on that interest to maturity of the contract. The denominations of these contracts vary, but they are typically written in amounts ranging from $1-100 million, with some ranging as high as $300 million.

While GICs have been offered by insurers for a number of years, BICs are a very recent entrant into the marketplace, first appearing in 1987. There appear to be several factors that kept banks from issuing BICs to large defined contribution plans prior to that time. First, it was not until 1986 that the FDIC eliminated a requirement that deposit records disclose the names of settlors and trustees and contain an account signature card executed by the trustee. This requirement made the issuance of a BIC to a large defined contribution plan administratively impractical. Second, it was not until recently that several accounting firms for pension plans apparently concluded that BICs were entitled to the same book value account treatment as GICs. Book value accounting, which will be discussed further, has become an essential marketplace convention for defined contribution plans. Finally, in 1985 the FDIC issued the first of what has become a series of interpretative letters to banks concluding that BICs are entitled to pass-through deposit insurance treatment when issued in connection with trusteed pension plans.

Pass-through coverage in this context means that up to $100,000 in insurance is passed through to each individual participant in a pension plan funded by a BIC. Assuming, for example, that no one individual in a large pension plan has more than $100,000 in contributions, a $150 million BIC issued by a single bank would be fully insured by the FDIC.

The total size of the GIC/BIC market is estimated to be between $175 and $200 billion. New sales are running at an annual rate of about $35 billion. In 1987, BIC sales were estimated to be approximately $250-300 million. In 1988, that figure ballooned to between $1-3 billion, and in 1989 sales were estimated to aggregate $8-10 billion. In short, banks have literally gone from zero to almost a third of the annual market in just three years. The enormous magnitude of the BIC risk is brought into sharp focus when annual sales of $10 billion are compared with total estimated FDIC bank fund reserves of $13.8 billion at the end of 1989.

In early 1989, one pension broker estimated that about 20 banks either issued BICs or held themselves out as being in the market. By August of that year, the number had swelled to over 80. In contrast, there are only some 60 insurers in the GIC business.

There is no legal definition of either a BIC or a GIC. Banks generally describe their contracts as deposit agreements and insurers describe their contracts as group annuities. The contours of these contracts are dictated largely by marketplace convention and are identical for BICs and GICs. Features which frequently are present in these contracts and which serve to distinguish them from other obligations such as CDs are their so-called "window" provisions for the inflow of funds and their "benefit responsive" provisions pertaining to the outflow of funds.

The "window" is essentially a contractual guaranty by the issuing institution that a predetermined rate of interest will be credited over the life of the contract to all deposits made during an initial defined period of time (the "window"). These window periods run from a matter of months up to a year. A one-year window is typical in this market.

An example of a "window BIC" would be a contract between a bank and a pension plan pursuant to which the bank agrees to credit interest at the rate of 10% for three years on all deposits made by the pension plan during the first year of the contract. The duration of the window period, the guaranteed rate of return and the duration of a particular contract may all vary considerably based on market conditions and negotiations. An important aspect of this type of contract is that from its inception, the interest guaranty applies to a deposit of indeterminate size. Only after the window period has closed is the exact size of the deposit known.

The "benefit responsive" feature refers to accounting rules that permit a BIC or GIC to be reported at contract (book) value rather than at fair market value. Book value accounting enables plan participants to transfer money in and out of a GIC or BIC at book value, and withdrawals are permitted without the imposition of any interest rate or market value penalty.

Risk Analysis

As noted above, BICs are unlike other bank deposits in that the deposit amount for which the interest is guaranteed is not definitely known at the time the rate is set. In addition, funds may be withdrawn by the pension participants who receive the pass-through insurance without any market value or interest rate penalty. Both these features are typical conventions of the market in which they are sold, and both mean that BICs - unlike the typical bank obligations - have significant inherent risks.

Both BICs and GICs are most typically sold to defined contribution pension plans as investments in the guaranteed rate or fixed income fund within the plan. The typical contribution is through salary deduction, and the guaranteed option usually is one of several investment funds within the plan which the employee may select.

The employer (the plan sponsor) must negotiate the rate to be guaranteed to employees prior to the start of the salary deduction period so that employees can be informed of the rate their funds will earn. This requires purchasing a BIC as much as two months before the first deposit is received. The bank must guarantee an interest rate for all deposits estimated to be made during the contribution or "window" period -- typically 12 months. Employees may change both the proportion of their salary that they contribute to the plan and the investment fund to which it is directed. They may also switch investments from one fund to another. Consequently, there is great uncertainty as to the amount that ultimately will be contributed under contract. The guarantor (BIC or GIC issuer) fully underwrites this financial risk.

This combination of relatively high yield and liquidity explains the popularity of the guaranteed fund option. It receives over 60% of the contributions in defined contribution plans with a guaranteed option according to a 1987 Bankers Trust survey of defined contribution plans.

The deposit "window" exposes the issuer to substantial antiselection risk. If interest rates fall, the guaranteed rate will be more attractive, and contributions will exceed the original estimate. The BIC or GIC issuer must purchase additional investments to back the guarantee at a much lower rate, and will lose money. If rates rise, the guarantee will look less attractive relative to other opportunities in the marketplace, contributions will fall below expectations, and the issuer will be required to sell at a market loss some of the assets originally purchased to back the guarantee.

Similarly, antiselection risk occurs because of the "benefit responsive" feature of these contracts. For example, if interest rates rise during the life of the contract, participants will withdraw their funds from the guaranteed account without penalty and place them in a higher yielding investment. To meet these withdrawals, the BIC or GIC issuer will be forced to liquidate underlying investments at a loss.

Other Deposits Distinguished

As the above discussion suggests, the contractual characteristics of BICs as well as their attendant risk factors distinguish these bank instruments from traditional deposit obligations such as CDs. Though somewhat of an oversimplification, it can be stated with a fair degree of accuracy that CDs typically place attendant risks on depositors while BICs shift most if not all of those risks to the issuing institution.

CD interest rates generally fluctuate with the prevailing interest rate environment. While a bank may guarantee a 10% rate on all deposits received today, a downturn in prevailing rates will result in the bank lowering its guaranteed rate tomorrow. In this way, a bank can continually match its investments with its guarantees and thus avoid the inflow risk associated with BICs.

Similarly, the outflow risk on a typical deposit obligation is distinct from the outflow risk on most BICs. A typical CD provides that any withdrawal before scheduled maturity will result in a substantial interest penalty. This penalty enables the bank to liquidate underlying investments to pay off the depositor while minimizing loss due to higher prevailing interest rates. BICs, of course, do not provide banks with this cushion against loss.

It is also worth noting that BICs appear to be the only type of bank obligations that has been permitted to take advantage of the same book value accounting treatment that the Financial Accounting Standards Board has permitted for GICs. Indeed, FASB's Emerging Issues Task Force reviewed the accounting treatment of GICs earlier this year and at the same time considered whether BICs should receive similar treatment. In discussing this issue with FASB, bankers asserted that virtually all transactions involving BICs take place at book value and that these obligations operate identically to GICs. Consequently, argued bankers, BICs and GICs should be treated the same by FASB.

Other Regulatory Considerations

An appropriate inquiry for this Committee is whether the overall bank regulatory scheme is designed to address the types of risks incurred by depository institutions issuing BICs. Given pass-through deposit insurance, the BIC purchaser has little incentive to avoid these risks and, consequently, bank regulatory oversight for this line of business becomes particularly important. Unfortunately, the present bank regulatory system does not appear to be geared to compensate for these risks. Several factors warrant mention in this regard.

The FDIC has advised the Council that its assessment of BICs simply involves determining whether the instrument is a deposit. If the answer is yes, and if that deposit is held under a trusteed arrangement, pass-through deposit insurance automatically follows. There is no evaluation of the relative risk of the instrument involved or the potential negative impact pass-through insurance treatment would have on the insurance funds. The same insurance treatment is accorded the most risky BIC and the least risky CD.

In the absence of risk-adjusted deposit insurance premiums, the inherent risk of BICs unquestionably exposes the insurance funds to far greater liability than do other deposits. Further, it is doubtful that the FDIC or any other regulator can accurately assess this risk on a bank-by-bank basis if BICs are simply lumped together on the books with traditional deposit obligations.

Moreover, present and even prospective deposit insurance premium levels are insufficient compensation to the FDIC for the risks it is underwriting. These premiums are charged in exchange for what is essentially an FDIC assumption of the credit risk associated with the issuing bank. Ideally, the premium charged should be at least equivalent to the bank's credit risk premium. The fixed income marketplace evaluates these types of risks daily, and when a firm goes to the marketplace to borrow funds, it is required to pay back the risk-free rate plus a risk premium. The risk premium is typically quoted as a spread over a comparable Treasury security.

Over the last nine years, the average spreads for financial institutions looking to borrow funds in the public market were 116, 85 and 63 basis points over Treasuries for single, double, and triple AAA rated institutions respectively. It is clear that a deposit insurance premium of even 15 basis points is woefully inadequate to compensate for this risk, especially when one considers that the strongest financial institutions are required to pay on average 63 basis points over Treasuries in the public market.

An additional regulatory consideration involves bank capital requirements. These requirements are predicated on an evaluation of the asset side of a bank's balance sheet. Liability risks - the very risks that BICs entail - do not appear to be a relevant factor in establishing requisite capital levels. Thus, upward or downward spikes in interest rates could very well impair the capital position of a marginal bank that is engaged in the issuance of BICs.

We also understand that banks report their asset-liability matches to regulators only on business involving obligations with a maturity of less than one year. Since virtually all BIC business is for durations of a year or more, asset liability mismatches for this type of business would likely not be detected until it was too late to take corrective action. Moreover, if banks take the position that BICs are nothing more than CDs with a different name, one wonders how regulators will ever be in a position to assess accurately an individual bank's exposure to this business.

Deposit Insurance Policy Issues

We believe that the foregoing discussion demonstrates that BICs entail substantial inherent risks, and financial institutions issuing those contracts incur risks that are markedly different from the risks attributable to traditional deposit-taking activities. Given the typically large denominations of BICs, the size of the overall market, and the increasing number of smaller banks entering the business, it is also clear that continuing to insure these obligations on a pass-through basis will expose the insurance funds to multi-billion dollar liabilities. What, then, are the policy considerations that bear on this issue? We believe that a fair evaluation of the policy issues involved demonstrates conclusively that pass-through deposit insurance for BICs is both dangerous and unnecessary.

Legal Considerations. Considerable confusion has surrounded the legal underpinnings of the FDIC's opinion on pass-through deposit insurance for BICs. Much of this confusion has arisen because of apparently conflicting statements from the agency over whether pass-through coverage is required as a matter of law or is a product of agency interpretive discretion.

A review of the relevant statutes and the history of the FDIC's pass-through interpretations reveals quite clearly that pass-through for BICs is not required as a matter of law. Indeed, the only instances in which the banking statutes provide for deposit insurance on a pass-through basis are with respect to IRA and Keogh plans (see §11(a)(3) of the FDIA and §405(d)(3) of the NHA). Beyond these plans, pass-through is purely a creature of FDIC interpretation and could be eliminated immediately if the agency chose to do so.

Moreover, a legal assessment of pass-through indicates that Congress never intended for the FDIC to have the authority to expand the scope of deposit insurance coverage in this way. The FDIC's rulemaking authority was granted solely for the purpose of clarifying and defining insurance coverage in gray areas, since Congress recognized that the statute could not cover every conceivable situation. By looking at the IRA and Keogh provisions, it is absolutely clear that when Congress intended pass-through coverage, it did so specifically. Extending pass-through beyond IRA and Keogh plans is directly contrary to the intent of Congress and is, therefore, beyond the FDIC's authority.

Pension Protections. A fundamental consideration in reviewing the propriety of pass-through insurance for BICs is whether it is necessary or appropriate for federal deposit insurance to guaranty banks' sophisticated pension activities. We submit it is not.

The FDIC's interpretative position on pass-through predates the type of bank obligations with which we are concerned. It also predates the markets in which these contracts are sold. Most importantly, it predates ERISA. There is little doubt that Congress enacted ERISA for the purpose of protecting pension plans and plan participants. ERISA establishes fiduciary obligations requiring as a matter of law that pension plan fiduciaries evaluate the relative strengths of alternative pension plan investments. As a practical matter, providing deposit insurance to BICs on a pass-through basis means that the FDIC is supplanting to some extent the obligations imposed by ERISA. This is not an appropriate role for the FDIC or federal taxpayers.

Some employers and others have expressed the view that they would prefer that pass-through deposit insurance on BICs remain, since a federally insured investment is more desirable than an uninsured investment. This is certainly an understandable position. But, it argues equally well for federal insurance for all pension plan investments. Such a move would undoubtedly find favor with plan fiduciaries and plan participants. However, Congress has not determined that the federal deposit insurance mechanism should absorb the investment risks of the private pension system.

It should also be remembered that the issuance of BICs to pension plans is still a very recent development. Prior to 1987, when BICs first appeared in the marketplace, pension plan managers had no trouble selecting sound alternative investments for defined contribution plans based on the credit ratings and the management expertise of competing institutions.

In sum, the FDIC should not be placed in the position of supplanting the responsibilities of ERISA fiduciaries in the large defined contribution plan market.

Market Discipline. Much has been written recently concerning the need for market discipline to be imposed on depository institutions and the extent to which a lack of this discipline contributed to or substantially worsened the severity of the collapse of the thrift industry. The legislative history of the FDIA makes clear that Congress understood the risks of implementing a federal deposit insurance system and recognized the need to balance the stability and confidence that such a system provides against the need to maintain some degree of private sector credit scrutiny.

It is one thing to have the deposit insurance system protect small depositors and prevent runs on banks. It is quite another to guaranty the sophisticated pension activities that banks conduct through the issuance of BICs. The objectives of the Banking Act of 1933 and all subsequent amendments to that Act can be fully satisfied without the presence of pass-through deposit insurance for BICs.

Reputable economists generally believe that federal insurance guarantees increase rather than reduce risk-taking by covered financial institutions. Lee Hoskins, president of the Cleveland Federal Reserve Bank typifies these sentiments when he stated recently that "... instead of strengthening the safety of the system and guarding against bank failure, the combination of regulation and federal deposit insurance has encouraged more risk taking in the financial industry." Similarly, Robert Parry, president of the Federal Reserve Bank of San Francisco, stated that the present deposit insurance system encourages financially weak institutions to take what are in his words "bet-the-bank gambles." Mr. Parry argues that "market discipline is the most effective means of controlling risk taking by financial institutions." He goes on to note that the most likely sources of market discipline are large depositors. An appropriately structured system should protect small depositors through insurance coverage and force large depositors to exercise market discipline. Of course, this is precisely the end result of eliminating pass-through insurance on BICs.

Brokered Deposits. The way in which the thrift industry weakened and ultimately collapsed demonstrates the harm that can result from the solicitation and receipt of "hot" money such as brokered deposits. Congress' concern on this point is reflected in Section 224 of FIRREA, which limits the ability of "troubled" institutions to accept brokered deposits.

Providing pass-through deposit insurance for BICs creates the opportunity for the very type of mischief that result from the brokered deposit phenomenon. In fact, institutions with relatively poor credit ratings (though not "troubled" within the meaning of Section 224) may find it easier to attract large sums of money by issuing BICs than by soliciting brokered deposits. Rather than having to place deposits in several institutions, the pooled funds available for deposit can be placed into a single BIC contract and receive virtually full deposit insurance coverage. There is nothing to prevent a weak bank from soliciting BIC business at guaranteed rates above those of healthy competing banks or companies. In a market environment that is highly rate sensitive, the weaker institution has a reasonable chance of attracting funds by guaranteeing a marginally higher rate of interest.

Bankers have asserted that since BIC funds are invested by ERISA fiduciaries, only banks with the highest credit ratings will be able to attract BIC business. Experience is already proving the fallacy of this notion. FDIC insured institutions with the lowest investment-grade credit rating have successfully attracted BIC funds, and the importance of pass-through insurance in this context is obvious.

Factoring in the inherent risk of the product (which in and of itself could weaken a bank's capital position), the prospect of marginal banks issuing large denomination BICs may be even more dangerous than if the bank simply solicited brokered deposits.

Without pass-through deposit insurance, market discipline would preclude weak banks from significant participation in this type of business. We believe that market discipline should operate to prevent the weak shopping center bank from dabbling in BICs just as it prevents the weak shopping center insurance company from marketing GICs. Congressional action to enhance market discipline can not come too soon given the rapidly growing number of banks entering this business. In this regard, it is important to note that smaller institutions are beginning to discover the appeal of BICs as a source of funds.

FDIC Response

The FDIC's response to concerns over pass-through coverage for BICs has been both surprising and disappointing. We believe that the agency's reaction to and position on the issue should be of concern to Congress.

There is without question a growing body of opinion that the deposit insurance system is substantially overbroad and must be reined in. The interplay of deposit insurance and the current problems being experienced by the thrift and banking industries is the subject of intense discussion in financial circles and in Congress. Against this backdrop, the FDIC's deliberative process appears to involve simply a narrow legalistic analysis of whether the most expansive interpretations of permissible insurance coverage can be sustained. There is a decided absence of thoughtful attention to the many important policy considerations involved in this debate.

Indicative of the FDIC's apparent disdain for congressional prerogatives is the fact that at the same time Congress has indicated its intention to assess the propriety of pass-through insurance for BICs, the FDIC has proposed a series of rules and regulation designed to codify and strengthen its decision to extend pass-through coverage for these very contracts! This action goes far beyond the provisions of FIRREA requiring the agency to harmonize disparate FDIC and FSLIC interpretations.

The FDIC has an obligation to adhere to sound policy considerations as it administers and interprets the statutes for which it is responsible. This obligation is not satisfied merely by advancing the broadest interpretations that might be sustained in court. In any event, the FDIC should table its codification of pass-through coverage until Congress has had ample opportunity to consider changes to the deposit insurance system.

CONCLUSION

Restructuring the financial services industry and revamping the deposit insurance system are both critical issues for the life insurance industry. And, as this Committee recognizes, the two issues are interrelated in many ways.

The Council does not believe that a persuasive case has been made for granting banks expanded insurance powers. If nothing else, the terribly costly collapse of the thrift industry has taught us that new powers are not the solution to the perceived problems of depository institutions. Well managed institutes can be both profitable and competitive without being all things to all people.

Even absent some further shuffling of bank powers, we believe that aspects of the deposit insurance system need immediate reform. The elimination of pass-through coverage for BICs is one of these aspects and can be easily accomplished. This action will inject needed market discipline into the banking system without sacrificing the protections for which the deposit insurance system was originally fashioned.

The CHAIRMAN. Mr. Irons.

STATEMENT OF WILLIAM V. IRONS, PRESIDENT, IRONS AND ASSOCIATES; RHODE ISLAND STATE SENATOR; REPRESENTING THE NATIONAL ASSOCIATION OF LIFE UNDERWRITERS

Mr. IRONS. Thank you.

Mr. Chairman and members of the committee, I am an insurance agent, a State Senator in the State of Rhode Island, and one of five members of the Rhode Island Board of Bank Incorporation, the regulatory authority for State-chartered banks in our State. I serve as Chairman of the Federal Law and Legislation Committee of the National Association of Life Underwriters. I appear today on behalf of the national insurance agent trade associations that have traditionally opposed bank entry into the insurance business.

We believe that the goals of the Federal Deposit Insurance System mandate that bank powers not be expanded.

The purpose of the Federal Deposit Insurance System is to safeguard consumers and the smooth functioning of our economy. But, because Federal deposit insurance largely removes the risk that depositors will suffer if their banks fail, banks have been removed from the pressures of the marketplace in a way other businesses are not.

The point is simply that banks operate in an environment different from the rest of us.

Insurance agencies have the freedom to fail and in the 1980's, quite frankly, some agencies did fail as the result of free and open competition.

Insurance agents compete all the time. Some of us operate as independent insurance agencies. Others work for only one company. The competition between independent insurance agencies and captive agents has been fierce. Some other insurance companies—GEICO, for example—don't use insurance agents at all.

These different methods of distribution offer a variety of choices to the consumer. None of us ask Congress to intervene in the marketplace to give one method of distribution an advantage over the others.

So as you can see, insurance agents are not afraid of competition. We don't want to be protected. We are not asking for the Federal Government to guarantee our products and we are not looking for a Washington bailout if we fail.

It must be recognized, however, that banks operate in a totally different environment. Federal deposit insurance gives banks several advantages over the insurance agent who is not affiliated with a bank.

More importantly, the nature of the banking business combined with the law of Federal deposit insurance threatens the best interests of the consumers.

First, banks are allowed to use federally insured products as a means of attracting customers. Insurance agents are not. This ability of banks creates the very real danger and I would submit the reality of tie-ins. Coercion is not theoretical. My customers are fearful that they will suffer if they are turned down for a loan. It's fashionable these days to disregard the problems of tie-ins. Some economists tell us that tie-ins cannot even exist. In a marketplace with competitive bankers, they say, and competitive insurance sellers, that no seller can charge an above-market rate and that any buyer who is subject to coercion would just switch to another bank.

That is just sheer fantasy. A family applying for a mortgage in Pawtucket, Rhode Island is awfully eager not to offend the local bank. A small business in Providence will go to extreme lengths to protect its line of credit. These people and these businesses may understand that they have a theoretical right to shop around for credit, but in the real world they are worried about their credit record and what would happen to them if the first bank they approached turns them down.

When time is of the essence, they are also afraid that their home purchase or the pending business transaction will collapse before they can find a backup lender.

But you do not have to take my word for it. Is anyone willing to stand up and defend the record of banks in the sale of credit insurance, the one form of life insurance traditionally open to them?

Credit insurance is a national scandal. Recently, the insurance commissioner of North Carolina testified that he had been the subject of illegal bank coercion even while serving as the insurance commissioner. In a compilation of recent reports from insurance agents observing the sale of insurance by financial institutions demonstrates that coercion exists, coercion need not be explicit, financial institutions use their position as lenders to obtain an unfair competitive advantage, financial institutions use various schemes to favor their captive insurance agencies, and financial institutions have placed insurance without their consumer's consent. This I have experienced with my clients.

Second, the presence of Federal deposit insurance gives banks an easy source of inexpensive capital that provide banks an unfair means of funding expansion in to the insurance business.

Third, the mix of federally insured products with uninsured or State-guaranteed products can be very misleading to the consumers. We have seen that happen in the savings and loan context.

Consumer groups now recognize either that bank powers should not be expanded or that strong safeguards must be put in place, but Federal regulators have ignored these warnings.

The Fed's Merchant National order permits bank holding companies to avoid the limitations of the Bank Holding Company Act no matter what nonbanking activities are conducted—insurance sales, insurance underwriting, real estate development, or anything else.

The Office of the Comptroller has embarked on a campaign to expand insurance powers of national banks and even to preempt State laws protecting insurance consumers.

Let me take a moment to address another argument—that banks need expanded powers to bolster their international competitiveness.

First we hear that the banks are the biggest—the Japanese banks, but Japan has a much more concentrated banking system. This nation, by contrast, has been appropriately concerned that too much concentrated power may work against, not for, the best interests of our consumers. And in any event, Japanese banks aren't big because they can sell insurance. Japanese banks are barred from the insurance business.

Second, bigger is not always better. A very important economic yardstick of success is return on equity. The top nine U.S. banks have a higher rate of return on equity than the most profitable Japanese banks. Still, U.S. banks say they want insurance and other nonbanking powers to increase their profitability.

Are we ready to believe that the U.S. banks will all of a sudden increase their ability to compete worldwide because they have been given the power to sell a life insurance policy? The focus should be on banking issues.

If we want to help our banks, let's talk about the U.S. savings rate. In other words, how to increase our worldwide standing by encouraging citizens to save. That would help the banks and it would help our American economy.

That brings me to my third point about international competitiveness. Consumers well-being should not be sacrificed merely because Japanese or European banks are big. For the reasons I've already discussed, consumers would not be well-served by expanded bank powers. In short, expanded bank powers has nothing to do with international competitiveness. Reform of the Federal Deposit Insurance System should proceed swiftly, but only in a way that truly safeguards consumers.

I would be more than happy to answer any questions.

[The complete prepared statement of William V. Irons follows:]

TESTIMONY OF

THE HONORABLE WILLIAM V. IRONS, CLU, LUTCF
NATIONAL ASSOCIATION OF LIFE UNDERWRITERS

COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS
OF THE UNITED STATES SENATE

Testimony is presented on behalf of

The Alliance for the Separation of Banking and Insurance
Independent Insurance Agents of America
National Association of Casualty & Surety Agents
National Association of Life Underwriters
National Association of Professional Insurance Agents
National Association of Surety Bond Producers

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Summary of the Testimony of William V. Irons

Mr. Chairman, I am an insurance agent, a state Senator in the State of Rhode Island, and one of the five members of the Rhode Island Board of Bank Incorporation, the regulatory authority for state-chartered banks in Rhode Island. I serve as Chairman of the Federal Law and Legislation Committee of the National Association of Life Underwriters. I appear today on behalf of the national insurance agent trade associations that have traditionally opposed bank entry into the insurance business.

We believe that the goals of the federal deposit insurance system mandate that bank powers not be expanded.

The purpose of federal deposit insurance is to safeguard consumers and the smooth functioning of our economy. But, because federal deposit insurance largely removes the risk that depositors will suffer if their banks fail, banks have been removed from the pressures of the marketplace in a way other businesses are not.

Insurance agents compete all the time. We don't want to be protected, we are not asking the federal government to guarantee our products, and we are not looking for a Washington bailout if we fail.

It must be recognized, however, that because banks operate in a different environment, federal deposit insurance gives banks several advantages over the insurance agent who is not affiliated with a bank. More importantly, the nature of the banking business combined with the lure of federal deposit insurance threatens the best interests of consumers.

First, banks are allowed to use federally-insured products as a means of attracting customers. Insurance agents are not allowed to offer federally-insured deposit accounts. That is combined with the very real danger of tie-ins.

Coercion is not theoretical. My customers are fearful that they will suffer if they are turned down for a loan. Recently, the Insurance Commissioner of North Carolina testified that he had been the subject of illegal bank coercion even while serving as Insurance Commissioner. And a compilation of recent reports from insurance agents observing the sale of insurance by financial institutions demonstrates that (i) coercion exists, (ii) coercion need not be explicit, (iii) financial institutions use their position as lenders to obtain an unfair competitive advantage, (iv) financial institutions use various tricks to favor their captive insurance agencies, and (v) financial institutions have placed insurance without their customers' consent.

Second, the presence of federal deposit insurance gives banks an easy source of cheap capital that gives banks an unfair means of funding expansion into the insurance business.

Third, the mix of federally-insured products with uninsured or state-guaranteed products can be very misleading to consumers. We have seen that happen in the savings and loan context. Consumer groups now recognize either that bank powers should not be expanded or that strong safeguards must be put in place.

But federal regulators have ignored these warnings. The Fed's Merchants National Order permits bank holding companies to avoid the limitations of the Bank Holding Company Act no matter what nonbanking activities are conducted -- insurance sales, insurance underwriting, real estate development or anything else. The OCC has embarked on a campaign to expand insurance powers of national banks -- and even to preempt state laws protecting insurance consumers.

Reform of the federal deposit insurance system should proceed apace -- but only in a way that really safeguards consumer interests.

Mr. Chairman. My name is William V. Irons. I own and operate an insurance agency in Rumford, Rhode Island and I serve as Chairman of the Federal Law and Legislation Committee of the National Association of Life Underwriters, which represents this nation's life insurance agents.

I appear today on behalf of NALU and the other national insurance agents trade associations: The Independent Insurance Agents of America, National Association of Casualty & Surety Agents, National Association of Professional Insurance Agents, and National Association of Surety Bond Producers. Together, we have urged Congress to retain the traditional separation between banking and commerce.

I am an insurance agent. But my familiarity with the issues confronting this Committee is not limited to my professional background. I serve as a Senator in the State of Rhode Island and as one of the five members of the Rhode Island Board of Bank Incorporation, the regulatory authority for state-chartered banks in Rhode Island.

Because of my background, I especially appreciate the opportunity to offer my views on the question of deposit insurance reform. In that context, this Committee has specifically asked whether new powers should be granted to banks or their affiliates. We believe, for reasons we will detail today, that the goals of the federal deposit insurance system and, more generally, the federal safety net, mandate that bank powers not be expanded.

I. Federal Deposit Insurance is Designed To Help Consumers

The purpose of federal deposit insurance is simple: to safeguard consumers and, in a more general way, the smooth functioning of our economy. Federal insurance assures families that the savings they deposit today will be available tomorrow, despite any financial difficulties encountered by their bank. By deterring bank runs, the presence of federal deposit insurance also ensures that panic will not strike the banking system and impair its ability to act as the intermediary that matches borrowers and depositors.

And federal deposit insurance has done more. It has encouraged savings, which assists in the formation of capital, and, especially in thrift institutions, it has helped to raise the money borrowed by millions of Americans to buy their own homes.

These are important, indeed imperative, goals. But, as this Committee knows, the existence of federal deposit insurance has a byproduct that can be dangerous. Because federal deposit insurance largely removes the risk that depositors will suffer if their banks fail, my banker friends have been removed from the pressures of the market place in a way that most of the rest of us are not. That's not a good thing if it encourages bankers to use depositors' money for their own narrow purposes in a manner that either brings risk into the banking system or endangers the consumers that federal deposit insurance is designed to serve.

Protection of bank activities has gone beyond the statutory limits of the federal deposit insurance system. Continental Illinois is the best example. The rescue plan put in place by federal authorities guaranteed that no depositor -- and even no creditor -- would lose any money. They acted out of fear that losses to uninsured depositors and creditors would create an intolerable risk of market stability.

We are not here today to criticize that strategy. The "too big to fail" doctrine has come under attack, perhaps deservedly so. On the other hand, we recognize that federal regulation has been based on the notion that banks -- for the good of their customers -- must be protected from the vicissitudes of competition.

II. The Presence of Federal Deposit Insurance Gives Banks An Unfair Advantage When They Enter Nonbanking Businesses -- And Threatens to Harm Consumers

The point is simply that banks operate in an environment different from the rest of us. Insurance agencies have the freedom to fail. And in the 1980's, quite frankly, some insurance agencies did fail, as the result of free and open competition.

Insurance agents compete all of the time. Some of us operate independent insurance agencies. Others work for only one company. The competition between independent insurance agencies and captive agents has been fierce. Still other insurance companies, GEICO for example, essentially dispense with insurance agents altogether. These different methods of distribution offer a variety of choices to the consumer and, although some of us may feel quite strongly about the advantages of one over another, none of us ask Congress to intervene in the marketplace to give one method of distribution an advantage over the others.

So, as you can see, insurance agents are not afraid of competition. We don't want to be protected, we are not asking for the federal government to guarantee our products, and we are sure not looking for a Washington bailout if we fail.

But banks are different. They offer federally insured deposits, and of course, they have use of the money brought into the bank by virtue of federal deposit insurance. If permitted to engage in the sale of insurance banks, would be given, in other words, several competitive advantages over the insurance agent who is not affiliated with a bank. Even more importantly, the nature of the banking business combined with the lure of federal deposit insurance threatens the best interest of consumers if banks are permitted to engage in nonbanking activities.

First, and most obviously, banks have access to customers who want to put their savings in a secure place. That may not sound like much, but it makes a big difference. Professional relationships are built on experience. If the federal government gave me exclusive access to an insurance product, it would allow me to form relationships that I could parley into the sale of other, more widely available insurance products.

The word "relationship" is, of course, the new buzzword of the banking industry. "Relationship banking" is all the rage. That's because "relationship banking" not only takes advantage of access to customers, but also uses the inherent advantage of selling insurance or real estate or anything else to a loan applicant. And the danger of coercion further distinguishes banks from other insurance sellers.

It's fashionable these days to disregard the problems of tie-ins. Some economists tell us that tie-ins can not even exist. In a marketplace with competitive bankers and competitive insurance sellers, they say that no seller can charge an above-market rate and that any buyer subject to coercion will just switch to another bank.

That's sheer fantasy. I deal with a lot of people. A family applying for a mortgage in Central Falls, Rhode Island is awfully eager not to offend the local bank. A small business in Providence will do quite a bit to protect its line of credit. These people and these businesses may understand that they have a theoretical right to shop around for credit, but they are worried about their credit record and what will happen to them if one bank turns them down. And, when time is of the essence, they are also afraid that their home purchase or pending deal will collapse before they can find a back-up lender.

But you do not have to take my word for it. Is anyone willing to stand up and defend the record of banks in the sale of credit insurance, the one form of life insurance traditionally open to them? Credit insurance is a national scandal.

Consider the well-known example of two Missouri bank holding companies whose record of credit insurance activities was examined by the Fed and the federal courts in the early 1980's. One of the bank holding companies had 38 banking subsidiaries selling credit insurance. 14 of the 38 had penetration rates of 80% or better. Four of the subsidiary banks had penetrations rates of 100%. Has any truly competitive business ever been able to sell to 80 or 100% of its potential customers?

And was this remarkable success based on a better price? Not at all. As one federal judge wrote, the evidence revealed "the spectacle of an extremely successful 'sales program' peddling overpriced coverage to a captive market." Independent Insurance Agents of America, Inc. v. Board of Governors, 736 F.2d 468, 474 (8th Cir. 1984) (Ross, J., dissenting).

No one is immune from tie-ins. Indeed, Jim Long, the Insurance Commissioner of North Carolina, told a House subcommittee earlier this month that he has personally been subject to bank coercion to buy insurance during the time that he has been the Insurance Commissioner -- despite the existence of federal and state laws outlawing such tie-ins.

At the same hearing, the National Association of Casualty & Surety Agents submitted a report of unfair bank activities gathered from around the country. These arise in the sale of commercial policies as well as personal lines. NACSA members report:

> --That coercion exists. When a small business sought a multi-million dollar commercial loan from an Arizona thrift, the thrift asked the owners of the business to sign a loan agreement that would guarantee the purchase of insurance from the thrift so long as the thrift could provide insurance coverage at a competitive -- but not necessarily the best -- price. That's an explicit -- and illegal -- attempt to tie loans to the purchase of insurance.
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> --That coercion need not be explicit. A North Carolina bank was approached for a commercial loan in excess of two million dollars that would be used to purchase a business. Insurance on the business could be expected to cost at least $25,000. Before the loan was made, the loan applicant was told that it would "help" if insurance were purchased from the bank's insurance agency. Sure enough, it was.
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> --That financial institutions use their position as lenders to give them a competitive advantage not available to insurance agents who are unaffiliated with a bank. The best example concerns confidential customer information. When a bank makes a loan on property or to a business it has a legitimate need to examine the loan customer's current insurance policy covering property that serves

as collateral on the loan. But when it turns that information over to its insurance agency, the information needed by the lender is being unfairly exploited by the bank's insurance agency. A thrift in Louisiana tried just that tactic, although it was wise enough not to keep it in effect.

--That financial institutions use various tricks to favor their captive insurance agencies. In New Jersey a mortgage lender set requirements for an acceptable insurance policy that would be almost impossible for anyone other than the thrift insurance agency to fulfill and another financial institution charged a penalty fee when an insurance policy was moved from the captive insurance agency. A bank in South Carolina said that insurance would only be acceptable if purchased from a particular insurance agency.

--That financial institutions have placed insurance without their customer's consent. Last year, a lawsuit in Pennsylvania revealed that the Mellon Bank was placing credit insurance on just that basis. Previously, we've reported to Congress that a thrift in Ohio simply added the cost of unnecessary and unwanted homeowner's insurance to a loan customer's account because he failed to answer an insurance solicitation sponsored by the financial institution. In other words, the thrift was trying to force mortgage customers, who already had insurance in place, to object if they did not want additional insurance. The same practice was recently reported to us by a NACSA member in Texas.

Second, the presence of federal deposit insurance gives banks a easy source of cheap capital. Obviously, that's a good thing when federally-insured deposits are used to make loans to businesses, homeowners and the like. But is it fair that banks should be able to acquire the capital to enter my business because they are able to sell a federally-insured product not available to me? Suppose I want to buy an expensive new computer system for my agency and a bank in the insurance business wants to do the same. Is there a legitimate federal goal served when a bank can "borrow" the money to pay for that computer network more cheaply that I can? If there is, it's not apparent to me.

Third, and most importantly, the mix of federally-insured products with uninsured or state-guaranteed products can be very misleading to consumers. This is the crux off the matter; will consumers be better off if banks are permitted to engage in unfettered insurance activities?

As I said at the outset, the goal of the federal deposit insurance system is consumer protection. But recently we have seen that customers of federal savings and loans can be easily confused about whether they are buying federally insured products or not.

In light of this kind of experience, it's no surprise that consumer groups are concerned about the problems that arise when banks enter nonbanking businesses, including the sale of insurance. The witnesses this Committee heard from this month exemplify those doubts. The Association of Community Organizations For Reform Now (ACORN) completely opposes expansion of bank powers. The Consumer Federation of America, which has supported bank powers, nonetheless "continued to warn of the problems related to the selling of insurance by banks, particularly of proper disclosure and tying, which must be addressed properly." Public Citizen concluded that insurance powers "may" be beneficial, but only when "coupled with strong safeguards."

Given the experience of the thrift crisis and the concerns voiced even by those consumer groups supportive of some expanded powers, it is amazing that federal regulators are working feverishly to expand nonbanking powers. And they are doing so without any safeguards in place.

The Merchants National Order issued by the Federal Reserve Board permits bank holding companies to shrug off the constraints of the Bank Holding Company Act simply by performing banking activities directly within a subsidiary bank. Rather than providing consumer safeguards, the Merchants Order yields the worst possible result. Nonbanking activities beyond the scope of the BHCA are forced into the subsidiary bank: The one place in the bank holding company system where the danger to consumers is the greatest. Would any rationale scheme of regulation designed, as the BHCA is, to reduce tie-ins and consumer coercion actually require that nonbanking activities only be conducted in the offices of a bank and not in separate nonbanking subsidiaries?

And it's important to remember that the Merchants Order is not confined to insurance or even to insurance sales. The Fed has concluded that the Bank Holding Company Act does not apply to any kind of nonbanking activities conducted directly within the bank, from insurance sales, to insurance underwriting, to real estate development, to anything else.

The Office of the Comptroller is not far behind. In the past few years, the OCC has launched a frontal attack on congressional intent. It has authorized branches of national banks located in small town to sell insurance to customers located anyplace in the world. It has permitted the underwriting and sale of municipal bond and title insurance. Just this year, it authorized the sale of both variable and fixed annuities. And, far from imposing consumer safeguards, an OCC lawyer has recently argued that state laws protecting insurance consumers cannot even be applied to national banks. This is a radical -- and dangerous -- reworking of the law.

CONCLUSION

The savings & loan crisis demonstrates what happens when the regulators get out of control. The same danger exists right now for the commercial banking industry, in the aftermath of the *Merchants* Order and the Comptroller's obvious intent to change the rules before Congress can act. That should not be allowed to happen. Reform of the federal deposit insurance system should proceed apace -- but only in a way that really safeguards consumer interests.

The CHAIRMAN. Thank you very much.

Let me ask each of you if you think the deposit insurance system needs to be changed and, if so, in what way? Mr. Flynn, let me start with you.

Mr. FLYNN. We actually haven't taken a hard look at the deposit insurance. We started our deliberations this past week now that your committee is looking at that. I have appointed a special study committee to examine that and we will take formal action on it in November and as soon as that's completed or as it unfolds we will be happy to provide written testimony on it.

The CHAIRMAN. Very good. We want your formal thoughts on that matter. When they are completed please send us your thoughts.

Mr. FLYNN. We certainly will.

The CHAIRMAN. Mr. Friedman, let me hear your thoughts.

Mr. FRIEDMAN. Mr. Chairman, if you'd like, I'll continue on the BIC question.

The CHAIRMAN. Fine, and then I want you to go to this question of how you think the deposit insurance system needs to be changed, if at all.

Mr. FRIEDMAN. All right. Let me begin with the BIC question.

There are basically two reasons why I believe that passthrough insurance is a misuse of the deposit insurance system.

The first is that it results in gross competitive inequalities and the second is that it poses dangers to the deposit insurance system.

It results in competitive inequalities because it provides every bank issuer of BIC's with a credit rating on a par with that of the U.S. Government, a credit rating higher in effect than that of every AAA insurance company. The bank share of the BIC-GIC market has grown to one-third of current sales in a 3-year period. That is clearly a result of the passthrough of deposit insurance.

I think it's a danger to the deposit insurance system because it potentially represents a wholesale version of brokered deposits. There are now 80 banks in the BIC market. The Bank of New England—and I don't mean to pick on it, but it's obviously a bank that's been having problems. The Bank of New England, for example, is a BIC issuer and there's no reason why any bank can't be a BIC issuer on a wholesale basis.

So what it allows a bank to do is gain market share by paying higher rates. It doesn't need a Merrill Lynch distribution system to distribute brokered deposits to individuals because these securities are issued in denominations of hundreds of millions of dollars and allows a bank to grow extremely quickly and puts the risk on the deposit insurance system.

In terms of your more general question, Mr. Chairman, about whether the system needs reforming, I think there's no doubt that it needs reforming. What I'm about to express is a personal view, not a view of the Council.

I personally believe that it is important that the core deposits, the core savings of people be insured, that people ought not to be required to make investment judgments for their life savings. It's something that just can't be done efficiently. It would lead to a radical restructuring of the banking system because it would result in a major flight to quality and it would be a terrible problem for smaller banks. So an adequate level—and I think personally $100,000 is not a bad level—is very important.

To me, the principal challenge—and I don't have an answer to it—is to find a way to avoid effectively insuring large deposits. I think if we can do that, then market discipline will work and we will achieve our other goal of protecting the deposits of retail consumers.

The CHAIRMAN. Mr. Irons.

Mr. IRONS. Mr. Chairman, we have no formal position, but we are reviewing the reform proposals. These hearings so far—the material that we're looking at and hope to have a formal position by the end of the year to present to your committee.

We would point out, as the other witnesses have referred to, the Merchants National order we think creates a bigger dilemma than has existed before because it is now expanding the areas and giving an approval to them moving in and we think it will be an accelerated pace. So, therefore, movement to correct or deal with that from Congress, which is where we have looked for several years—and we must say the Senate has responded—we have never been able to get a bill all the way through the process. It is now, we think, more important than ever that some legislation come forth to stop the regulatory erosion of what was Congress' intent.

The CHAIRMAN. Thank you, Mr. Irons.

I'm going to have to excuse myself because I have to go to the Budget Committee. I'm going to ask Senator Graham to continue the hearing at this point. There are a number of questions that I want to put to you. I will try to get back before you finish, although I don't know whether I'll be able to do so.

In any event, let me give the gavel to Senator Graham.

There is one question I'd like to pose to you before I excuse myself.

With respect to the international competition argument, it is obvious that banks are very concerned about Europe 1992 and other things that have been mentioned here this morning. Do any of you see any actions that we should be considering to help American banks to compete more effectively internationally?

Mr. Flynn, do you have any thoughts? Let me go right down the table to get your responses. Then Senator Graham will continue the hearing.

Mr. FLYNN. Thank you, Mr. Chairman.

Again, the real estate community has little interest as a community or as an industry—the National Association has little interest in the world bank situation and therefore has not taken a formal position on that matter.

Mr. FRIEDMAN. Mr. Chairman, I have no suggestions for the banks. I think that American banks are competing effectively abroad. They are establishing strategic alliances where they are not able to function alone and I expect them to do very well.

Mr. IRONS. The argument really—your question is whether or not the decision to compete more effectively means to grow larger in size.

The record we think shows that our national banks, when measured by profitability, compete very effectively and very competitively.

The question is, is bigger better? We don't think that a lot of instances show that and in this nation we have always believed in many competitors being better for the consumer.

If the question is how can they be bigger, then obviously we need to go to a more nationally structured system of banking and allow interstate banking to grow. I know in our area in New England—you weren't here when I started, Senator—I am a State Senator, regional banking is growing and I have voted on a number of occasions to allow that to happen and to allow the banks to be more competitive in their arena. But there is absolutely no validity to these requests for expanded powers moving them into a more competitive stature. When you look at other countries where they do have it, which is not Japan, the biggest, their expanded powers have nothing to do with their competitive ability.

Senator **Graham**. First, let me express my appreciation for your being here and my apologies for my late arrival and if I should ask a question that has already been covered, if you would so indicate, and you may treat it in as terse a manner as you wish.

One of my concerns in the issue of the international aspect is that the essential focus, in my opinion, should be on the American business or business individual and the ability of the financial institution structure to facilitate the successful accomplishment of mission and ability to be competitive with their economic competitors around the world.

I'd like your comment from that perspective, of how well do you feel the current financial institution structure will allow our business people to have access to capital and other services that will place them in a competitive position vis-a-vis European or Asiatic competitors.

Mr. **Irons**. Senator, I would use an analogy that I would hope would be understood easily and that is, I look at the EC 1992 situation at this stage, when I don't think many really understand anywhere what will be, as one that you approach gradually rather than jumping in with major changes in our domestic structure to try and anticipate what no one knows.

But I look at the potential playing field, if you will, as the national baseball arena in our society. There are parks in California, Candlestick, with a lot of wind and weather. In Boston we have a very large green monster, the left field wall; and in New York they have Yankee Stadium where the right field was once designed for Babe Ruth. But each player that comes into those respective arenas knows what the rules area. They come in and the home team usually does have a distinct advantage and I don't think that will ever change, but when they get in, what really makes them the winner is how well they train to play in that arena.

Now with the one caveat that I mentioned a moment ago about changing us to a more national structure, I see the argument is not competitiveness; it's bigness. And our banks are successful proven by their profitability ratio.

I think that it is a ruse to implicate that the expanded powers into real estate or insurance will have anything to do with it. What it will do and what they have done well in this country is once they are into those arenas understanding how high the walls are and what the weather is, and then I think our banks will be extremely competitive. Will they be as big? Only time will tell.

Senator **Graham**. If I could pick up on that baseball analogy—and I'm a great baseball fan and I'm old enough to remember when the Boston Red Sox used to regularly trade and try to get right-handed power hitters so they could take advantage of that short, tall left-field wall. I remember when they got Gene Stevens from the old St. Louis Browns to take them to permanent supremacy in the American League. It didn't quite work because they had to play half their games in other than Fenway Park and I'm concerned that our American business people are going to be playing increasingly half their season outside the United States and whether the type of environment that we have created will allow them to win at Fenway Park but also win enough games away that they will be successful at the end of the season.

Mr. **Irons**. Well, I concur with your concern, Senator, but the only thing that we would input to this is, it makes no sense for us to redesign the park before the ballgame begins.

Second, we have one of the most innovative economies over history and leaders in banking and industry up until the recent history, and I think as this new dawn approaches for us to make moves that jeopardize the consumers' buying rights—I speak now of the insurance area—because of not knowing what the park size is or the wall or who the players will be, is a real disservice to the consumer of American; and second, very likely—the Merchants National being the best example of this—can be extremely damaging to a system that is already in great danger.

Senator **Graham**. Mr. Flynn, you can use other analogies if you like.

Mr. **Flynn**. Having observed your deep background in baseball analogies, I certainly will use another one.

I think the answer is, can we compete worldwide without major restructuring of the banking institution, and I believe that we can. In fact, deregulation and expanded powers doesn't necessarily make us more competitive. The instances where there were opportunities in deregulation in the EC 1992 resulted in what's referred to as the "big bang" in London and the "little bang" in Canada, where our banks felt that with those expanded powers they could go over and be profitable, rushed over and branched banks in those areas, found out that the market was so darned competitive it was not profitable and quickly closed and stole away into the darkness.

So expanded powers doesn't necessarily mean again expanded profitability or a more competitive edge or a nature. I think we do best when we stick to our knitting and stick to banking and the central banks and our Federal Reserve Board with the branch banking system and the world economy we have I think we compete more than efficiently and effectively.

By having expanded powers doesn't necessarily mean that they will be more profitable, nor will they be less competitive. When we do what we do well—and that's understand credit risks and invest wisely and soundly and are well protected, our depositors are protected. So we believe there doesn't have to be major readjustment in that area.

Mr. **Friedman**. Senator, I take your question to really address itself to the question of the availability of capital to American business rather than the challenges to the banking system, and I don't think there's a problem.

We have the broadest, deepest and most efficient capital markets in the world and we still do, and American companies have full access to capital markets in Asia and full access to capital markets in Europe. They access those capital markets quickly, efficiently and cheaply when it's cheaper to finance there than it is to finance here.

If we have a capital problem, it is not on the debt side; it's on the equity side. That problem—and we do have a problem. The cost of equity capital is too high in this country. That is a function of the savings rate and of macroeconomic policies. That has nothing at all to do with this debate.

Senator **Graham**. Senator Shelby.

Senator **Shelby**. Thank you, Mr. Chairman.

If we are interested in banking—and I believe we are—as public policy dealing in and making public policy to make sure that the banking system is, number one, stable for all the citizens of America, which brings forth right behind it the safety and soundness. If it's stable, it's going to be basically safe. That is so important to the average saver in America and to a financial system that is going to support a free market economy which supports a democracy. Do you agree that that should be our number one goal coming out of this committee?

Mr. **Friedman**. Absolutely.

Mr. **Flynn**. Agreed.

Senator **Shelby**. How can "x" bank that has a subsidiary, for example, or did have one, that would make loans to this subsidiary to develop property or to speculate in real estate and other things—how can that bank be unbiased, fair, and make sure that ultimately the FDIC fund is protected? Mr. Friedman.

Mr. **Friedman**. Well, I think one always treats members of the family differently than the way you treat other people. The banks would argue——

Senator **Shelby**. And there would be a different treatment, wouldn't there?

Mr. **Friedman**. I think without question, sure.

Senator **Shelby**. If it were my bank or your bank or what? That's just human nature, isn't it?

Mr. **Friedman**. Yes. But I think there's a more fundamental problem because the banks would argue that it's possible to construct prohibitions on loans between the bank and other subsidiaries, the whole firewall debate.

Senator **Shelby**. The Chinese wall.

Mr. **Friedman**. Chinese walls were really invented to prevent flows of information in the securities area and the term has been misused, but you could say to a bank—the banks wouldn't like it—"You can't advance any funds of any sort to any subsidiary." I think even that, which is a drastic solution, doesn't end the problem.

It goes back to what I said in my oral statement about confidence. When Continental Illinois got into trouble, the Federal regulators announced that no depositor of any size would lose one penny by leaving their money in Continental Illinois, and still there was a massive outflow.

Senator **Shelby**. That was the "can't fail" doctrine, wasn't it?

Mr. **Friedman**. Yes, but it doesn't work because a large portion of these funds are held by fiduciaries and a fiduciary is not prepared to take any risk whatsoever. A fiduciary is not willing to bet that its bank—the bank where it has funds on deposit, will not be the first bank that is not to big to fail.

Senator **Shelby**. That goes back to safety and soundness, doesn't it?

Mr. **Friedman**. Yes.

Senator **Shelby**. And the stability of the system?

Mr. **Friedman**. Exactly.

Senator **Shelby**. And the perception of the safety and soundness.

Mr. **Friedman**. Yes.

Senator **Shelby**. Mr. Irons, do you have a comment?

Mr. **Irons**. Yes, Senator. Several years ago I was testifying before the House Banking Committee on this same subject, although then the premise of the banks was expanded powers were needed not for international competitiveness but to serve the consumers of America, that we're going to find this great growth in the number of outlets and reduce prices. The discussion then was of firewalls, not Chinese walls.

The comment we made then was, the analogy of the firewall inside of a car. The firewall inside of a car is to protect the occupants if there is a fire in the engine. But we said then, that's a possible analogy, but what happens when the car is destroyed? The firewall did no good for the occupants. And I think we've seen that come to pass in the S&L situation.

The problem with a firewall is you must have enough regulators in place overseeing the system because, as you pointed out so well, human nature will never change. The father will always favor the son or daughter and that's something that in most instances is an important part of our society. In fact, too often now missing.

But in reality, in this arena, it is too dangerous and it will make the system unstable, not just for the banks, but as we've seen, for the consumer.

So we don't believe that you should build a structure where you have to have firewalls. You just can't maintain them.

Senator **Shelby**. Mr. Flynn.

Mr. **Flynn**. In direct answer to your question, I don't think they can differentiate or can draw a line between a wholly owned affiliate.

Senator **Shelby**. You've been a banker? You said earlier that you had been affiliated with a bank holding company?

Mr. **Flynn**. That's correct.

Senator **Shelby**. And a real estate business?

Mr. **Flynn**. That's correct.

Senator **Shelby**. You've done some of all of it, so you've sat on both sides of the table, have you not?

Mr. **Flynn**. Exactly. In fact, there is no way that you can differentiate between an affiliate and yourself. In fact, if you take the alarming case that Mr. Friedman talked about where you would disallow banks to make any loans at all to any affiliate, that may be the worst possible business move for that affiliate. In fact, if it's a real estate business and you couldn't make any loans to that affiliate or any business within that affiliate, it would cut off all mortgage possibilities for the consumer and it might not be the most competitive for the consumer itself.

So there is an inherent conflict of interest when you bind those two together and the most important part of that is when you have that affiliate with the capital of the bank in it it is at risk. It is venture capital. It's money that you take from that institution and place in another business. Venture capital, by definition, is at greater risk than other investment opportunities and I think would violate in many instances some of the investment policies of banks if they really took a hard look at it, and certainly the regulators under today's environment, if they looked at the risk ratio of that kind of investment, would put it under strong advisement, in my judgment.

Senator SHELBY. Besides trading in futures, what would be basically a bigger risk than real estate?

Mr. FLYNN. Well, we would hope there would be Las Vegas and Atlantic City probably.

Senator SHELBY. Other than that?

Mr. FLYNN. It does require a great deal of sophistication to invest in real estate. There are many of us who spend full-time trying to analyze those risks and to achieve the reasonable rewards because of those risks. We are subject to all sorts of outside influences, including the 1986 Tax Reform Act, which this body saw fit to pass, which changed the rules midstream for many investors and therefore it does make it a riskier venture.

On balance, the operation of brokerage houses and firms we think today is a very difficult and risky business and it would not be in the best interests for the stability that you talked about earlier of the institution to be involved in that business.

Senator SHELBY. Most of you are familiar—I guess everybody is familiar with the problems with the S&L industry. We certainly are in the Senate Banking Committee. If there's one thing we have learned—and I hope it's many lessons—out of that is the risk in real estate, where a lot of thrifts were speculating in that as partners and as other things, subsidiary owners and so forth. And we don't know what the total bill is going to be there yet. We might not know for several years. Heaven forbid, should we have to revisit something like that with FDIC.

I, for one, as far as bank powers, as far as modernizing the financial services industry, I believe that we should modernize it, but that the financial institutions should stay with financial instruments. I don't have any real problem and I have supported legislation to let the commercial banks into investment banks. I see a connection there. But I refuse to see that—I can't see it where it would help them, it would protect FDIC funds, protect ultimately the American taxpayers, be good for business, for them to be in high-risk real estate and insurance.

Thank you, Mr. Chairman.

Senator GRAHAM. Thank you, Senator.

Traditionally, the determination as to banks' involvement in real estate, insurance and other collateral activities has been at the State level. Could you comment as to how well you believe that federalized decision process has functioned and your comments on it in the future? Do we need to have a national standard for this or can we continue to let these issues be resolved at the State level?

Mr. FLYNN. To the extent that State institutions are involved in the real estate business—and I believe 22 States have given certain powers to those institutions to get into the businesses—first, it has not been widespread as far as getting into the brokerage business directly. Those that have gotten in, in many instances, have experienced the potential losses of being in another business has done and have gone and phased out of the business. It would be in the best interest if you were to set a Federal policy to examine some potential firewalls to preserve and protect the safety and soundness of those State-chartered institutions that are in those businesses.

I don't know that it is within the purview—it is within the purview of the Federal Government to in fact restrict State rights to do that, but in my judgment, at least some firewall protection so that they don't inordinately risk the capital and the safety and soundness and integrity of those institutions, because as you know, the average citizen does not differentiate easily between a State-chartered and a federally-chartered institution or bank.

Mr. FRIEDMAN. Senator, the life insurance business is unique in the sense that in it represents the only form of national financial institution that is wholly State-regulated I think that in some States—my own State of New York, for example—that system has worked extremely well. The New York regulators are experienced, tough, and very attentive to what they do. And that affects not only life insurance companies that are chartered in New York but also those that do business in New York.

There is, however, without doubt, a wide disparity in the quality of regulation at the State level. I think one could not speak as highly of the regulators of all states.

In addition, over some considerable period of time, because the question is an extraordinarily complex one, the adequacy of the State-guarantee funds is also something that needs to be looked at more closely.

I think it would be a significant mistake to rush into the establishment of Federal standards and to try to establish a Federal guarantee fund at this time. The role of life insurance companies in our financial services industry and the role of Federal regulation is something that is going to be addressed by the Congress over the next 15 years. It's going to require a lot of attention and a lot of very careful thought.

Mr. IRONS. Senator, we believe in the life industry and in the agents associations that the present structure of State regulation is a proper structure. While there are—and admittedly so in any system—some States that are better than others at the regulation, when one studies the amount of manpower that is applied to the regulation of insurance and with the assistance of the National Association of Insurance Commissioners, and then one looks at the level of manpower and resources that the SEC applies, there is no comparison. I would submit to you that any attempt to become a federally regulated industry would result in more problems rather than less.

The one thing that is lacking—and here I have to be very complimentary to this body, the Senate—the one thing that is lacking on the Federal level, we had a good Federal structure, but because of inaction by the House, the inability to get a bill all the way through and signed, we are seeing erosion in the bank holding company system. I think that is a real danger.

But I do believe that the State regulated system, when one studies it fully, sees the manpower commitment and admittedly in some areas not as high as they would like in the States—I know that's true in my State—but I can assure you the Federal ability to regulate that would be less, it would be much more costly, and I submit to you that I think it would be less effective.

Senator SHELBY. Mr. Chairman.

Senator GRAHAM. Senator Shelby.

Senator SHELBY. Something that has been rather frustrating and I suppose perplexing at times has been the chipping away of what we thought were the laws as to what Congress has passed making public policy as to what financial institutions could do or not do and so forth. This is done administratively and then upheld by courts and so forth.

It's frustrating to some of us in the Senate and I'm sure in the House that it's not the people's elected representatives making public policy. It's administrators. It's the Federal Reserve Board. It's the various courts and so forth.

I know that we have had these issues before this committee, but I think it's long past time that we come in with strong, clear legislation as to how we are going to modernize our financial institutions.

Mr. Irons, do you have any comment? Do you agree with that?

Mr. IRONS. Well, I surely support fully your position, Senator. The one interesting change since 2 years ago is we have changed the word "deregulation" to "modernization." I just hope that in the process of getting this——

Senator SHELBY. Who coined that term, do you know?

Mr. IRONS. No, I don't. I'd like to meet him. We know what it means in many instances. We know there is some need for modernization, but we surely hope it isn't an attempt just to deregulate or expand powers.

I apologize. I lost my train of thought. Let me back off for a minute.

Mr. FRIEDMAN. Senator, I have been on all sides of these issues. I was in charge of capital markets policy at the Treasury in the late 1970's. I have been an SEC commissioner. I've spent a lot of time as a lawyer working for banks. I've taught this at Columbia Law School. And I was executive vice president and general counsel of a major securities firm. And I have watched this closely since at least 1978. It's very clear to me that the regulators have merely responded to the enormous pressure that the markets have placed on the financial institutions they regulate. If one were to administer the Glass-Steagall Act and the banking laws as they were enacted in 1933 according to the spirit of 1933, the regulated industries would not be viable. So some change and some accommodation to these enormous changes in the market were required.

The right place for those accommodations is the Congress. For a variety of reasons, the Congress wasn't prepared to do that. So the regulators, without any policy guidance, have been doing what you call chipping away. Some of the things they have done I think are good and some things are bad. But the critical absence here has been the unwillingness of the Congress to deal with the fundamental policy issues—to provide guidance for the regulators. So I agree completely that the overall architecture of the financial system is a matter for the Congress and having the Congress act on it is of critical importance.

Senator SHELBY. Where there is a vacuum like this in the making of public policy or inaction or something, oftentimes that void will be filled, and it's being filled administratively.

Mr. FRIEDMAN. That's exactly right.

Senator SHELBY. Mr. Flynn.

Mr. FLYNN. I would concur that there has been erosion and a chipping away and I guess now having heard Mr. Friedman's varied background, it sounds like your panel is a group of job-hoppers that you have up here with the variety of different backgrounds. I would concur that there has been erosion and the Merchants National case I think is a classical case of the regulatory agencies moving and the court cases now reestablishing a new mechanism to circumvent some of the regulatory authority that you had built so carefully into the law.

I think part of the overall modernization, if you will, or looking at the financial services community would be to tighten those reins and tighten the language so that in fact it's run from the Congress where the elected representatives who are accountable and can be held accountable for them actually do design the financial services background that we need.

Mr. IRONS. Senator, if I could just finish, we have for a number of years now sought this resolution in the Congress, but one of the things that we feel very strong about is, while there has to have been some modernization that had to occur with the regulators, we do believe that in the very recent past—and the Merchants National ought to be the best example that we can cite—there is no longer an effort to modernize or adjust. It's taking the banks' particular cause and taking advantage of the vacuum. The court decisions say, in essence, you are right on philosophy but we are not going to argue with the regulator involved because that's the way we feel the regulator has the right in the absence of other findings.

We feel that there is a definite bent in the regulatory authority presently to put them into arenas that Congress definitely did not intend them to be into.

Senator SHELBY. I have no more questions, Mr. Chairman.

Senator GRAHAM. There has been some representations that the concerns that you have expressed in insurance and real estate areas of coercive or tied relations with banks should be authorized to enter your business could be dealt with through the antitrust laws.

From your perspectives, could you comment as to how effective a shield you think that would be against the potential abuses?

Mr. Irons. Senator, I would say totally ineffective. When you have an insurance commissioner of a State tell you that he was approached in a tie-in in testimony to this Congress, I think that shows the level to which it can go.

But the real world that exists in America is the fact that the person who is either implied or unimplied involved in a tie-in situation, the tying factor is a smaller part of the overall picture and the average small businessman of America is not going to sue his bank because he feels that his property casualty insurance is 20 percent higher than it should be or, as is shown repeatedly, that the credit life insurance on his mortgage can be bought a lot less at a lot lower cost, he is not about to sue his bank and jeopardize his mortgage. Most Americans fear that it is a collective group in the banking community and if you're a troublemaker you pay for it dearly.

So the tie-in situations are always the tail on the dog. That's why the consumer is not going to sue. The small businessman is not going to sue, not even going to bring it forth.

Senator Graham. Any other comments?

Mr. Friedman. I think that the antitrust laws would be effective to prevent a bank from announcing a program broadly that had tie-in relationships in it. But as Mr. Irons has pointed out, these influences are far more personal and subtle. They have to do with the relationship of an individual customer to an individual banker or salesman. The antitrust laws don't function at that level. They just don't have anything to do with the real world at that level.

So the decision is either to tolerate that degree of coercion—and there is some implicit coercion; even if the banker says nothing other than, "by the way, we've got a great insurance department," there's some implicit coercion in that. And it's a competitive advantage. One ought to have a good reason for putting banks in that position.

Mr. Flynn. The coercion and tie-ins I think are more subtle in the real estate business rather than overt. Therefore, I think the likelihood of enforcement of that would be extremely low. So, from our perspective, I concur with both of the preceding witnesses' comments on it. We just don't think it would work.

Senator Graham. One of the issues that have been alluded to that we are going to be dealing with over the next period will be the reform of the federally insured deposit system. I was interested in finding that as far back as the Eisenhower administration there have been proposals for a restructuring of deposit insurance, particularly to break the linkage between regulators and insurers, recognizing that they have different perspectives in carrying out their functions.

Do you have any recommendations as to what we ought to be looking at in terms of deposit insurance and the relationships between deposit insurance and regulation?

Mr. Friedman. Senator, I think the chairman asked that question just before you arrived.

Senator Graham. Fine. I will read the response to that question and will not pursue it further.

Mr. Friedman, you made a comment that you felt that the Congress had not been dealing with the fundamental issues necessary for reform of our financial institutions.

From the diverse background that you bring to this issue, what do you think those fundamental issues are? What should be our agenda in terms of congressional intention?

Mr. **Friedman**. This is an area in which there is no certainty. There are no absolutely right answers. The critical questions are in a sense less ones of structure than questions of values. That is, how important does the Congress think stability is? What degree of conservatism do you really want to build into the banking system?

You can't ask a banker that question. The banker's job is to make money. There is an inverse relationship between risk and profitability. So these fundamental questions of value are very important. They have got to be addressed and it's more important that the Congress speak clearly than that it try and be exactly right; there is no perfect answer to all of these questions.

I think the first question really has to do with the basic issue of how you feel about bank holding companies' firewalls and separate subsidiaries. If you accept the notion of substantially greater risks being placed in separate subsidiaries it's kind of a slippery slope. My own thinking has evolved considerably on this. Five or 6 years ago I was rather much of a proponent of separate subsidiaries and the idea that certain more risky activities can be more safely conducted in a separate subsidiary than in the bank.

I have grown increasingly skeptical of our ability to insulate a financial institution from a major problem in one subsididary. In 1981 I was practicing law and I was acting as counsel for the independent directory of Baldwin United when things started to collapse. It was impossible to insulate the insurance companies from things that were going on in other places and the other subsidiaries from things that were going on in the insurance companies. We just saw the same pattern with Drexel Burnham.

So my own view tends more toward conservatism on that issue. What that suggests to me is that even if separate subsidiaries are employed, their activities ought to be confined to activities that don't present substantially greater risks than banking.

In that context, remember that banking itself has become more risky. One could argue, for example, that a bank acting as principal is in a more risky business than the securities business without merchant banking. If you look at the losses that have accrued because of the series of lending excesses I mentioned earlier, and compare it to what's happened in the securities industry, I think one could make a very strong argument for that fact.

Now what follows from that? Does that mean that banking is risky and we should not let banks do anything but banking? I don't think so. But we should recognize that banking has become increasingly risky and it needs increasing focus, discipline, and attention.

Senator **Graham**. I wonder if one of the aspects of that riskiness of banking has been the declining competitiveness of intermediated capital markets from those that have a direct linkage between the lender and the ultimate borrower, the rise of securitized rather than commercial bank transactions.

Mr. **Friedman**. Well, in part. The first major example of that was the commercial paper market. The rise of the commercial paper market had the effect of taking the best credits away from the banking system. So the safest, best credits, the traditional banking business of short-term lending, isn't there any more. Increasing competitiveness on the capital-raising side has raised the cost of funds for banks. So funds cost more. Banks have to earn more to cover those costs of funds. All of those things push them out on the risk curve. The issue of securitization of credit card receivables raises a different question. Securitizing and selling those receivables is better for the bank, not only because it reduces its capital requirements, but because if it doesn't back them up it removes some degree of risk from its own balance sheet; but that's because it is laying those riots off on somebody else—on S&L's, on individuals.

The question is, do we really want to do that? My own answer is "yes." It spreads the word througout the system. I think the higher level of risk in the banking system is a fact of life. I don't think there's a whole lot we can do about that. The question is, how is that risk managed?

Senator **Graham**. We have been joined by Senator Heinz. Senator, do you have an opening statement or any questions?

OPENING STATEMENT OF SENATOR HEINZ

Senator **Heinz**. Mr. Chairman, I have a little bit of both, if the chair would permit.

First, I'd like to welcome Steve Friedman back to Washington, DC. He served with great distinction as an SEC commissioner back in the early 1980's, as I recollect. Steve, we are pleased that you are gainfully employed working for such a fine organization as we know The Equitable to be. Of course, that is not to say that Mr. Irons or Mr. Flynn are not well respected and well associated either.

I wasn't here early enough to welcome you. I had another hearing and another commitment at 10 a.m., but I do note that all of you expressed concerns about broadening the activities of the banking system. Your testimony states the funding advantages of deposit insurance, as well as the banking industry's control of credit, create a competitive playing field that dramatically tilts in the banks' favor.

You also point out that piecemeal decisions by the regulators and the courts are resulting in a financial services industry structure that you might describe as one that only Rube Goldberg could love.

Maybe Senator Garn or Senator Riegle or Senator Graham mentioned it, but the Senate has attempted to do its duty. We do not believe that decisions that involve such major policy issues as financial services should be made by unelected regulators, no matter how important their function as regulators may be.

So we have attempted to legislate on several occasions, most recently in the last Congress, and unhappily, we have found very little in the way of reciprocity from the other body. Obviously, we know how difficult all these issues are. There are many conflicts of interest. There's a lot of turf.

As a result, we feel that every time we take the bull by the horns the only person who ever gets gored is us. I wouldn't ask for the House to engage in a stampede, but we'd at least like them to walk down the cattle path with us so we could meet them more or less halfway, which around here means in conference.

At our last hearing on financial modernization—that's probably an oxymoron, Mr. Chairman. I can't imagine ever having a last hearing on financial modernization.

But in the hearing before this, the Investment Company Institute recommended that Congress create so-called narrow banks to limit the use of insured deposits to investments in safe liquid assets.

Now that's a new idea, a different approach. Would it adequately address concerns related to the competitive inequality created by deposit insurance that each of you basically referred to in your testimony? What in your view would be the advantages and disadvantages of the narrow bank approach recommended by the Investment Company Institute?

Since I said something nice about Steve Friedman, I'll take advantage of that and ask him to take that bull by the tail.

Mr. **Friedman**. My view is that the narrow bank is really a case of the tail wagging the dog. In order to protect the deposit insurance system, we are really completely manhandling the structure of the banking industry, which is a mistake. It's difficult enough for banks to cover their cost of capital. If you restrict their assets to Treasury securities and other very safe instruments, they are going to have to pay very low-interest rates on consumer deposits; it is true that they would be absolutely safe, but banks would lose substantial funds to money market funds and other intermediaries that pay market rates. I'm not sure what we would have accomplished except to provide deposit insurance for institutions that no longer need it. An institution that invests only in extremely safe assets really doesn't need deposit insurance. It's the equivalent of a money market fund that invests only in treasury securities.

The challenge of banking regulations is to design an institution that can compete effectively in today's world and still protect the core savings of lower and middle income savers. I think that can be done.

Senator **Heinz**. Mr. Irons, any comments?

Mr. **Irons**. Senator, we still have the basic overriding concern of the marketing problem. That is, while the structure may seem logical and able to be preserved for soundness, we believe the consumer is still in jeopardy of not being able to distinguish as in the S&L crisis coming into the bank and thinking they're dealing in one arena and they end up in another arena.

So for that reason, we don't think it is a good concept.

Senator **Heinz**. Mr. Flynn.

Mr. **Flynn**. Well, I'd like to begin first, Senator, by another matter unrelated to these hearings. Thank you for your recent cosponsorship of S. 2384, passive loss, and then to respond to your question more directly, while we as an association have not taken an official position on that particular proposal, it strikes me that if it's too narrow I would concur with Mr. Friedman that you would restrict the potential profitability of banks, that there are sufficient regulatory oversight and legislative authority granted currently which protect safety and soundness but allows certain investment policies that banks can get into to allow them maximum competitive value in the financial services market, not only in the country but worldwide.

If you're overly restrictive, then you disallow them the opportunity to make those profits and lower the cost of services.

We've also, in those activities, charged both Federal and State banks with a community responsibility of supplying credit and when you become so restrictive that they shrink down to a point where they are so out of warp with the money market funds from nonbank activities they would not have sufficient funds to provide that vital service to the community.

So, on balance, it would appear to be too narrow a view and, because I am representing the real estate industry here, we would see that investment directly in real estate or real estate development or in the real estate brokerage business would be a risk beyond most investment policies for the average bank at this time.

Senator HEINZ. Last month, Senator Dodd, the chairman of the Securities Subcommittee, and I, as ranking member, went to Europe; Brussels, Frankfurt, Strausberg, and London; to look at the implementation of the second banking directive and the related issues involving the fiscal and monetary union effort of the EC, which we tend to lump into EC 1992. I was quite surprised to realize that for the most part there is no extensive deposit insurance system in the European Community as we have in the U.S.

I don't know whether we could ever get or would want to ever get from where we are to where they are, but they've been there for a long time and they seem to be having a lot less bank failures than we do. We've got them outnumbered. We've got them out mega-bucked. So it's possible apparently to have a system without extensive deposit insurance.

If we had that kind of a system, would there be any reason for us to continue to separate, as we have traditionally attempted to do, the activities of banks from securities firms and insurance? They don't do that in most countries in Europe and the world hasn't come to an end. Indeed, the governments seem to be doing very little in the way of bailouts.

Mr. IRONS. Senator, I would respond and say that in the insurance buying setting that the FDIC, while it gives some advantages to the banks, is not the crux of the matter about keeping banking and insurance separate. It is the tie-in circumstances.

I mentioned just a few moments ago prior to your arrival the realities that really go on in American society, the homebuyer for that first mortgage or second mortgage in this day, which is triple what the first was, he's very nervous about his credit line. He is not going to object to an insurance—I've had this happen, personally seeing a client who was an existing client and bought the credit life from the bank and when I explained to him in a review how he could save money, he just would not do it. I said, "They won't do a thing to you. They don't mandate it." He would not do it. He was in fear that he would affect his relationship with the bank.

The small businessman who has a workmen's compensation problem, he has a property casualty problem, he needs bonds and so forth that must be extended in a minute's notice that he uses, he is not going to question the man who gives him the line of credit to keep his payroll going.

So while the FDIC is an important question, it is not the central theme as to why insurance and banking should be separate.

Senator **Heinz**. Mr. Flynn.

Mr. **Flynn**. It appears that as long as we have FDIC and the safety net that the Federal Government has supplied to the banking and financial industry in the United States that they have and would create an unfair playing field for us to compete in. What I think you're observing in Europe without that FDIC or safety net is a new and vigorous discipline within the banking community there to run whatever subsidiary operations there are profitably. As soon as we went to deregulation in this country with a big safety net you saw the savings and loan industry willy-nilly getting into businesses that were high-risk because they knew they had a safety net behind them and the quality of management and the quality of their operations and the quality of risk analysis and therefore failures multiplied dramatically.

If the playing field is level—and our complaint within the real estate industry is if banks do get into our business and have access to the Federal credit window and have the safety net so that if they do make unwise and imprudent business decisions and management decisions they are covered, when we in the private sector, without that coverage, are not covered is where the inherent disparity occurs.

If we're allowed to compete, we are more than content to compete head to head with whoever else is out there as long as they don't have that full faith and credit behind them. I think what you're seeing in Europe without that protection, the equal play between both ends, even though if you analyzed the European market many of those have restrictions even in those countries on what kind of real estate activities they're in, and many of them are restricted to just properties within the holding companies themselves.

Senator **Heinz**. Mr. Friedman.

Mr. **Friedman**. If one's objective is to protect the insurance deposit fund, then once there is no fund there's no need to regulate to protect the fund. But it seems to me there's even more reason to regulate to protect depositors.

Moreover, I don't believe that the absence of deposit insurance is going to result in more conservative management of financial institutions. And if that is not the case, which I think it plainly is not, then the same risks that we're trying to control to protect the deposit fund will be there except the risks will be transferred to depositors instead of the insurance fund.

Senator **Heinz**. Well, looking at the difference between the United States and Europe, would suggest that you're dead wrong: European banks are much more conservative than American banks.

Mr. **Friedman**. I quite agree that the banks are more conservative, but I don't think they are more conservative because there is no insurance fund.

Senator **Heinz**. They have minimized the risks and therefore those risks have not been transferred to the depositors. There have not been any noticeable number of bank failures. I think you have all answered the question. I thank you very much.

I thank Acting Chairman Graham for the opportunity to ask them. Thank you very much.

Senator **Graham**. Thank you very much, Senator.

Chairman Riegle has some additional questions which he might choose to ask you to respond to later if you would be willing to do so.

I would like, if I could, to take this opportunity, with such a distinguished panel, to ask a question in a collateral area.

That is, the impact on your industry—and I am particularly interested, Mr. Flynn—relative to what is happening in the savings and loan industry today.

In your opening statement, you discussed the National Association of Realtors' concern about the Nation's housing finance delivery system. I would like your impressions as to the impact of FIRREA, the savings and loan legislation of 1989, on that Nation's housing finance delivery system, any recommendations based on that for what you think Congress should be doing.

Mr. **Flynn**. That's an excellent question, Senator, and we have identified in the real estate community that one of the greatest challenges we have facing us during the 1990's is how we will deal with RTC and its impact overall on our marketplace.

Not only will it be the $200 billion or $500 billion of property now in foreclosure that needs as quick sale and at highest price as possible and how that impacts the various markets where these properties are now located, but also in the financial delivery systems where traditionally the savings and loans and thrifts had been mandated by law to provide financing for housing.

With the collapse of that industry and the very aggressive regulators that are now taking very stringent and rapid action in closing down those institutions, it's closing down some of the very significant former sources of capital in the real estate market and industry and in fact allowing savings and loans to come very quickly to banks underneath that FIRREA has taken ever more of those players who traditionally had supplied that capital out of the marketplace.

Some of that is being replaced by the secondary markets through Freddie and Fannie and Ginnie Mae's that are out there where banks do in fact become almost like mortgage brokers or bankers taking in the mortgage instruments and quickly packaging them and reselling them in the secondary market. They don't have the same commitment to housing and when other credit opportunities are either easier or more profitable we would see them out of the housing market and therefore diminishing in no small respect the amounts of capital available to our industry.

We think it deserves a second look by this committee as to exactly the direction that FIRREA is taking us with regard to the housing delivery vehicle. We will be pleased to monitor from our perspective, the National Association of Realtors, the activities throughout the country and make that evidence available to you, Senator, and this committee, as it does unfold because if it does result in substantial diminution of that capital, a substantial higher cost for that capital because of the aggressive regulatory stands that the new regulation is taking, we would put you on notice of that so that you might respond in time.

Senator **Graham**. Good. Thank you, Mr. Flynn. Your monitoring of that situation and advice to this committee would be very much appreciated.

Mr. Friedman or Mr. Irons, do you have any comment on that issue?

[No response.]

Senator **Graham**. Gentlemen, does anyone have any concluding statements that they would like to make?

Mr. **Flynn**. Just thank you for the opportunity.

Senator **Graham**. Thank you very much.

The meeting is adjourned.

[Whereupon, at 12:45 p.m., the hearing was adjourned.]

[Response to written questions and additional material supplied for the record follow:]

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April 11, 1990

Mr. Patrick Mulloy
Committee on Banking, Housing and
Urban Affairs
Dirksen Senate Office Building
Washington D.C. 20510-6075

Dear Mr. Mulloy:

As you requested in our recent telephone conversation, I am enclosing a copy of Professor Friedman's letter of January 17, 1990, which contained his responses to the questions sent by Senator Riegle.

Thank you for referring me to Mr. Edward Malan to acquire extra copies of the November 14 testimony. Because Professor Friedman's responses to the questions were not printed in the volume with his testimony, Mr. Malan offered to include them in the volume to be printed which will cover the testimony to be given on the modernization of the financial services industry.

Thank you for your assistance.

Sincerely,

Helen C. Deas,
Secretary to Professor Friedman

cc: Edward Malan ✓

HARVARD UNIVERSITY

Benjamin M. Friedman
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April 11, 1990

Mr. Edward Malan
Committee on Banking, Housing and
Urban Affairs
Dirksen Senate Office Building
Room 534
Washington D.C. 20510-6075

Dear Mr. Malan:

Enclosed an address label for you to use in mailing the 4-5 extra copies of the November 14 testimony of Professor Friedman. Also enclosed is an address label to you in sending 10 copies of his responses to the questions which you indicated would be published in the forthcoming volume on modernizing the financial services industry.

For your information, I'm also including a copy of Professor Friedman's letter of January 17 to Senator Riegle along with a copy of the question responses.

It was nice to talk with you and I appreciate your assistance. If I can be of any further help, please let me know.

Sincerely,

Helen C. Deas,
Secretary to Professor Friedman

cc: Mr. Patrick Mulloy

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United States Senate
COMMITTEE ON BANKING, HOUSING, AND
URBAN AFFAIRS
WASHINGTON, DC 20510-6075

December 11, 1989

Professor Benjamin M. Friedman
Economics Department
Harvard University
Littauer Center 127
Cambridge, Massachusetts 02138

Dear Professor Friedman:

Thank you very much for testifying before the Senate Banking Committee on Tuesday, November 14, 1989, at one of a series of hearings the Committee is holding on whether the American economy is in decline relative to our major competitors and, if so, the implications this has for our country.

In order to complete the hearing record, the Committee would appreciate your answers to the enclosed questions as soon as possible.

Again, I thank you for appearing before the Committee. If you have any questions, please contact Patrick Mulloy at 224-1571.

Sincerely,

Don Riegle

Donald W. Riegle, Jr.
Chairman

Questions for Professor Benjamin M. Friedman from Senator Donald W. Riegle, Jr., November 14, 1989 Hearing

Q.1. You and the other members of today's panel express a sense of urgency about the need to address what you on page 1 of your testimony say is America's "increasingly evident inability to compete in world markets." Many Americans, however, do not share your sense of urgency and have a feeling of economic well-being. Can you offer an explanation for this phenomenon if our country is truly in the rapid state of relative competitive decline that you describe.

Q.2. You claim in your book Day of Reckoning that we now have two debt problems in America. The first is the money our government owes as a result of borrowing to finance its record string of budget deficits. The second is the debt we owe as a nation as a result of borrowing abroad to finance our record string of trade deficits. The second deficit you say has very serious ramification's for America's political position in the world. Can you please explain why that is the case?

Q.3. During a hearing we had on October 5 on the condition of our banking system at which various industry experts testified, one expert, Mr. Sheshunoff expressed concern over the rapid expansion of foreign banks in this country. He stated:

> "Over the long term, control over a nation's financial institutions means control over which individuals and businesses are provided with credit and allowed to grow."

- Do you share Mr. Sheshunoff's concerns. If so, why? If not, why not?

Q.4. At that same October 5 hearing another banking expert, Dr. Kaufman, said the critical element in dealing with the rapid expansion of Japanese banks in this country is that U.S. banks in Japan should have access to lower priced Japanese savings so they can raise the same pool of funds and channel it back to our country if its needed here?

- Do you agree with Dr. Kaufman?

Q.5. Mr. Burstein, who also testified on November 14, stated on page 7 of his prepared testimony that:

> "...financial resources have replaced natural resources as sources of geopolitical power and influence...and the fact that Japan has obtained a disproportionate share of global financial power will fundamentally tilt the history of the 1990s and the early 21st Century towards Japanese leadership."

- Do you agree with his view?

Q.6. Mr. R. Taggart Murphy of the Chase Manhatten Bank in Tokyo claims in the March/April issue of the Harvard Business Review that:

> "Japanese commercial and investment bankers have succeeded overseas partly because of their diligence and attention to detail but also because they can offer lower spreads and lower fees to borrowers, thanks to the profits they enjoy from a cartel - like, protected market at home."

- Do you agree with Mr. Murphy's views and if so what should our government do to help American banks break into Japan's cartel - like protected market at home?

Q.7. Former Secretary of the Treasury Donald Regan and other advocates of the Reagan/Bush economic policies have told this Committee that the growing foreign investment in our economy is not a bad development, but rather is a reflection of the confidence foreigners have in our stable political environment and business climate.

- Do you agree with that assessment? If not, why not?

Q.8. Mr. Burstein stated on page 18 of his prepared testimony that:

"the U.S. trade deficit is now being compounded by the even worse current account deficit, and this will become a bigger problem over time as Japanese companies begin to repatriate their profits from the American market causing another major drain of dollars out of the system."

- Do you agree with Mr. Burstein's contention?
- What are the future implications of this development?

Q.9. Mr. Burstein also stated on page 22 of his prepared testimony that:

"...while our political leaders are busy spreading the gospel of free markets, our competitors are using intelligent, consciously - devised, government - led strategies to better manage their trade policies and the functioning of their market."

- Do you agree with that contention?

Q.10. You have pointed to our huge budget deficits as an overriding problem that we must solve to boost our national savings and investment. I am also troubled by our low private saving rates. Net saving rates of households and firms in the past 8 years are only about 2/3 what they averaged in the previous 35 years. Why is that? What can we do about it?

Q.11. As our social security fund builds up to pay for future benefits, we're taking the money and using it for current spending. Where will we get money to pay those benefits? Should we be trying to balance the budget as we currently measure it, or should we be trying to balance it without using social security funds?

Q.12. If we continue with our current policies, how do you foresee our trade and current deficits evolving? Can they continue like this indefinitely? If not, what will ultimately restrain them?

Q.13. Despite all the foreign capital that has poured into our economy, capital per worker in private business has hardly budged since 1981, after doubling in the previous 35 years. How critical is that to our future income growth?

- Can you quantify in some rough way what the cost of our current policies is in terms of our future income?

Q.14. An October 1988 publication of the Department of State's Center For The Study Of Foreign Affairs entitled "Japanese Investment In The United States" argues that:

"Japanese investment in qualitatively different than other foreign investment in the U.S. because [in part]... Japan is far more closed to American investment than are other countries investing in the U.S."

- Do you agree that Japanese foreign investment is in some qualitative way different from investment from other foreign countries?

Q.15. As you know many Americans are increasingly concerned over rapidly increasing foreign ownership of U.S. assets. Can you explain to us in a clear and concise fashion how increasing foreign ownership of America's assets is, in your view, related to our budget deficits?

Q.16. How much comfort can we take from the fact that, unlike Third World debtors, our foreign debt is denominated in our own currency?

HARVARD UNIVERSITY

BENJAMIN M. FRIEDMAN
William Joseph Maier Professor
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January 17, 1990

The Honorable Donald W. Riegle, Jr.
Chairman
Committee on Banking, Housing
and Urban Affairs
United States Senate
Washington, D.C. 20510-6075

Dear Senator Riegle:

Thank you for your letter of December 11, and thank you also for having given me the opportunity to testify before your distinguished committee in November. I believe that the problem of economic competitiveness is one of the most serious issues facing the United States today, and I therefore applaud the committee's interest and initiative in this area.

In this context, I appreciate in particular your continuing interest in my views, and I will try to answer as best I can the additional questions that you posed for the hearing record:

(1) It is certainly true that a sense of complacency about economic affairs is prevalent in the United States today. In many respects this situation is not surprising. After all, the unemployment rate is now lower than it has been in two decades; and inflation, while not as low as we would like, is certainly far below what it was a decade ago. In many respects, therefore, Americans believe -- and have a right to believe -- that "times are pretty good."

Nevertheless, as the hearings which you conducted clearly brought out, longer-run prospects for America's economic well being and international competitiveness are less than good. In some ways, this problem should already have made itself felt among the public at large. The average American worker's wage is not keeping pace with inflation. In 1983, the first year of the current expansion, the average worker in private business earned $281 per week. Today the average wage, restated in 1983 dollars, is just $271 per week. Hence people are actually losing ground, even now. More importantly, as we continue to build our debts and neglect our investments, we are not laying the basis for advances in productivity and competitiveness, and therefore in our country's standard of living and its ability to project its interests internationally as we move into the 1990s.

I believe that the crucial catalyst needed to cut through this complacency is leadership, from the highest levels in both government and the private sector.

(2) Yes, I do believe that the debt which the United States as a nation owes abroad has very serious ramifications for our country's political position in the world. The record not just of past decades, but indeed centuries, makes clear that whichever country is the world's leading creditor country plays a special role in global affairs -- in fact, exactly the role that our country has enjoyed during much of the past half-century. The historical record also makes clear that debtor countries do not play that role. As we now look forward to an America that is no longer a lending country at all, but the world's leading borrower -- and that on a truly massive scale, even compared to the huge size of our economy -- it is implausible that we can continue to project American democratic values and American democratic institutions in global affairs in the way to which we have become accustomed.

(3) I would not be concerned about the expansion of foreign banks' role in the United States if I thought that U.S. banks were able, both politically and financially, to undertake a comparable expansion in banking markets abroad: able politically, in the sense that other countries' governments and regulatory structures are as welcoming to our banks as ours are to their banks; and able financially, in the sense that America were once again a net creditor country, providing capital in foreign countries for expansion of American-owned and American-controlled business across a variety of lines of endeavor, banking included.

(4) Yes, I agree that the inability of foreign banks in general, and U.S. banks in particular, to make much headway in Japanese banking markets is a particular problem. In contrast to the large and growing share of U.S. banking markets now controlled by Japanese banking institutions, all foreign banks together (U.S. banks included) now have only a tiny share of the banking market in Japan. Moreover, that share is not growing. For just the reasons I have indicated immediately above, I think that this lack of symmetry will, at some stage, call into question the expansion of foreign banks' role in the United States.

(5) Yes, as I indicated above, historical patterns make clear that the world's leading creditor country (that is, the country which, more than any other, provides its investment capital for business expansion in other countries around the globe) has always played a leading role in world affairs -- not just economically but also politically, diplomatically, culturally, and even socially. Japan has now clearly emerged as the world's leading creditor country. Germany is not far behind.

(6) I lack the specialized knowledge to answer your question about the alleged cartel-like behavior of Japanese commercial and investment banks.

(7) I sharply disagree with the view that massive inflows of foreign capital into the United States since 1982 have reflected some sudden surge in foreigners' confidence in either the political environment or the business climate here. To be sure, foreign investors presumably do regard the United States as a good place to invest, for both political and business reasons. I hope they always will. But there is little reason to believe that their attitudes in this regard have changed radically within the past decade.

Instead, these massive inflows of funds have been the mirror image of the implosion of the U.S. trade account since the dollar began to become so sharply overvalued in the early 1980s. Simple accounting indicates that any country that runs a large current account deficit must experience a capital inflow. The United States is no exception. The relevant question, therefore, is not why these capital inflows have emerged but why they have occurred voluntarily -- in contrast to the unwillingness of private lenders to advance funds to many of the world's other countries with large current account deficits.

The answer, I believe, lies in the extraordinarily high real interest rates (that is, interest rates over and above inflation) that have prevailed in the United States since 1980. In earlier years, real interest rates in U.S. markets were typically somewhat below those abroad. Foreigners considering investments in the United States therefore drew a balance between the safer and more stable climate here and a modestly more attractive return elsewhere. But as the federal government's budget deficit ballooned in the early 1980s, real interest rates here suddenly rose to record levels -- and, in particular, to levels well above those prevailing abroad. Investing in dollar assets naturally became more attractive. To a large extent, this situation explains both the strong over-valuation of the dollar ever since and the fact that inflows of foreign capital into the United States have occurred voluntarily.

This short answer hardly does justice to what is a very serious, and in some respects a fairly complicated, set of issues. If further discussion would be helpful, I have dealt with these matters at some length in chapters VII and IX of my book Day of Reckoning.

(8) I have no way of knowing whether Japanese companies will begin to repatriate, rather than reinvest, the growing profits from their investments in the United States. Either way, however, the implications for the U.S. economy's prospects are not good. If these firms seek to repatriate their profits, then interest rates here will have to rise to levels that will attract replacement funds from other international investors. Those higher interest rates will then depress capital spending by U.S. business firms, as well as homebuilding by American families. Alternatively, if these companies continue to reinvest their profits, a growing share of U.S. business will be owned by foreigners -- importantly, without any corresponding increase in the share of foreign business owned by American interests -- and the United States will become an ever larger net debtor country.

(9) I do not know whether conscious trade and investment policies, devised and managed by governments, have been an important part of the story behind the competitive success of Japan and other countries. Some researchers have introduced evidence to that effect, while others have done the opposite. On balance, I believe that there is some strong element of truth in this contention, but I do not know how to assess how much.

For our purposes in the United States, however, the important issue is not just whether other countries have successfully pursued such government-led strategies but whether we could do so. Government actions that work well in other countries, operating under different political systems, are not necessarily helpful in the American context. I have strong reservations about our government's ability to carry out a successful government-led investment and trade strategy.

(10) One of the strongest lessons of the 1980s is that we simply do not know how to use government policy to manipulate private saving behavior. Most recipes for doing so translate into one way or another of raising the after-tax real return earned by savers. Yet a variety of factors combined in the 1980s to raise the after-tax real return enjoyed by U.S. savers to a post World War II record high: Because of our enormous federal government deficits, the real interest rates prevailing in U.S. markets were at record highs even on a before-tax basis. In addition, Congress lowered tax rates. Further, inflation was lower (which further reduced the effective tax rate on interest income, because the tax code is not neutral with respect to inflation). Finally, Congress also legislated expanded targeted saving incentives like Individual Retirement Accounts and Keogh Accounts.

But despite all of these factors, which joined to boost the after-tax real returns that U.S. savers could achieve to a record high, the U.S. private saving rate fell to a post World War II record low. Some analysts have suggested that either demographic factors or increases in asset values, or yet other influences, may have accounted for this decline in private saving. Careful and detailed research has shown that appropriate allowance for all of these influences cannot explain away why the private saving rate did not increase if saving behavior really were positively responsive to after-tax real rates of return.

On the basis of this record, it makes no sense to believe that we can solve America's problem of inadequate national saving entirely, or even largely, by stimulating private saving. Instead, the main approach must be to reduce the public sector's dissaving. That means cutting the federal government's deficit, through either spending less or taxing more (or some of both). At the same time, proceeding with some limited forms of targeted saving incentives probably still does make sense. For example, there is evidence that Individual Retirement Accounts did stimulate some net new saving at the margin. I therefore favor some forms of targeted saving incentives -- but not as a substitute for deficit reduction.

(11) As is now widely understood, the retirement of the post World War II baby boom generation, early in the twenty-first century, will place enormous strains on the Social Security System. For that reason, the President and the Congress agreed in 1983 to raise Social Security contribution rates to levels in excess of what would be needed to finance the Social Security System on a strictly pay-as-you-go basis between now and about the year 2010. During that interval, Social Security is therefore accumulating a large reserve -- a reserve that it will then decumulate, after 2010, as the ratio of beneficiaries drawing on Social Security to contributors paying into Social Security reaches an all-time high.

The fact that the Social Security surplus is simply being used to finance a part of the general government deficit means that, if the integrity of the

Social Security System is to be respected in the years after 2010, either the U.S. Government will have to run truly massive deficits, as it borrows from the market to repay what it owes to Social Security, or income and profit tax rates will have to rise sharply in order to fund these payments. Alternatively, the government at that time could break its promise to Social Security participants, either by reducing benefits (payable to Americans who by that time will have contributed to Social Security, at very high rates, for virtually all of their working lives) or by further increasing Social Security contribution rates payable by the next generation's workers -- exactly the two potential outcomes that the Social Security Amendments of 1983 were meant to avoid. Needless to say, neither of these choices is attractive.

The solution to this dilemma is that we should come far closer to balancing the federal budget without including the Social Security surplus.

(12) Under a continuation of current U.S. tax and spending policies, there is little reason to believe that the United States will become more competitive in the medium- to long-run future. This means that our businesses' ability to capture additional market share abroad, or even to recapture some of our markets here at home, will remain poor at current exchange rates.

As long as foreign investors are willing to continue to increase their holdings of U.S. assets, the United States can continue to run large trade and current account deficits for a long time. Eventually, however, when foreigners have accumulated what they consider to be a satisfactory share of their portfolios invested in U.S. assets, our interest rates will rise and the dollar will fall to a level at which the U.S. current account comes into balance. Given the enormous net debt position that the United States will have accumulated by that time, the current account's being in balance means that the trade account will have to be substantially in surplus. At that point we will, in effect, be working to produce not in order to consume at home but to service our debts abroad.

Once again, chapters VII and IX of Day of Reckoning address these issues in some depth.

(13) It is certainly true that the massive inflow of foreign capital into the United States in the 1980s did not translate into an increase in capital per worker in private business -- despite the fact that labor force growth slowed in the 1980s so that, in comparison to prior periods, less investment would have been needed to raise the capital-to-worker ratio. The main reason for this failure is that so much of what we borrowed during this period went, either directly or indirectly, into funding the U.S. Government's budget deficit, rather than into funding business investment in new plant and equipment.

This issue is indeed critical to our future income growth. If the United States continues on its current trajectory, our debt owed abroad (net of debt owed to U.S. entities by foreigners) will reach approximately 20% of U.S. national income by some time in the mid 1990s. Servicing that debt, at real interest rates comparable to today's levels, will take some 1-2% of our national income. In addition, at whatever time it is necessary for the United States to begin running a balanced current account (see immediately above), doing so will take an additional 2-3% of our national income. The overall sacrifice to Americans, therefore, will be of the order of 4-5% of our total national income.

(14) I do not know if foreign investment by Japanese firms is qualitatively different from that by firms from other countries.

(15) The increasing foreign ownership of America's assets is directly related to the U.S. government's budget deficit. Budget deficits, by absorbing the saving that American families and American businesses do, force firms seeking to finance capital investment and families seeking to build or buy new homes to compete all the more aggressively for that part of our saving that the government does not take. On average in the 1980s, the U.S. Government's deficit has absorbed in this way approximately three-fourths of all of the net saving done by U.S. families and U.S. businesses combined. The result of the increasingly aggressive competition for the one-fourth of our private net saving that remains available has been record high real interest rates.

These real interest rates have been high not only by our own historical standards but also compared to real interest rates available in foreign markets. As a result, foreigners have found U.S. assets unusually attractive. At any given time, however, there is only a limited quantity of dollar assets available for foreigners to hold. Foreigners attracted by high U.S. real interest rates have therefore had to bid among one another for that limited pool of dollar assets, thereby driving the dollar sharply higher in terms of foreign currencies.

Given the resulting overvalued dollar, American businesses have found it increasingly difficult to compete either in world markets or here at home. Hence the United States now imports far more than it exports. Our chronic trade deficit has, of course, become an issue unto itself. Its mirror image, however, is the huge inflow of foreign funds into the United States. When the United States buys more from abroad than it sells, the excess must be financed either by borrowing from foreign lenders or by selling assets to foreigner buyers. Moreover, even the amounts borrowed from abroad may thereafter be converted into foreign ownership of U.S. real property and business assets. Foreign investors who hold U.S. Treasury bills or U.S. bank CD's do not need official permission to cash in these debt instruments and invest the proceeds in either real property or business assets in the United States. They can do so at will, and they are evidently doing so in greater volume as time passes.

(16) For the present, the United States can take substantial comfort from the fact that the debt we owe abroad is denominated in dollars. One implication of this fact is simply that it represents foreigners' willingness to lend to the United States voluntarily -- a situation not now enjoyed by Mexico, Brazil, Argentina or any of the world's major problem debtors. As the U.S. net external debt ratio continues to rise, however, one can only wonder how much longer this favorable situation will last. As of yearend 1988, the debt owed abroad by the United States (net of debts owed to the United States

by foreigners) amounted to 10% of U.S. national income. As of yearend 1989, that ratio was probably 13%. It is continuing to rise, and by the mid 1990s it will probably reach some 20%. This level compares to debt ratios of about 25% for Brazil, and perhaps 35% for Mexico. Under the circumstances, therefore, the time may be coming when Americans will not be so readily able to borrow from abroad via instruments denominated in dollars.

Further, the more indebted the United States becomes abroad, with debts denominated in our own currency, the greater will be the inevitable pressures to return to high inflation. After all, by resorting to inflation we have within our power the ability, for all practical purposes, to expropriate a part of foreigners' holdings. To do so, however, would be to give up the one genuine economic policy success that the United States achieved in the 1980s -- the reduction of inflation. Perhaps because of foreigners' fears of such an outcome, the share of foreigners' U.S. holdings being shifted from nominally denominated debt instruments into direct ownership of real property and business assets is continuing to increase.

* * *

I hope that these responses will be useful to you and your colleagues on the committee.

With best personal regards,

Sincerely yours,

Benjamin M. Friedman

BMF/hd

SIA
SECURITIES INDUSTRY ASSOCIATION
WASHINGTON OFFICE: 1850 M Street, N.W., Washington, D.C. 20036 (202) 296-9410

June 20, 1990

Ms. Lory Breneman
Chief Clerk
Committee on Banking, Housing and Urban Affairs
United States Senate
Washington, DC 20510-6075

Dear Ms. Breneman:

Enclosed are responses to the questions of Senator Heinz following my testimony on financial modernization issues at the Committee's hearing on April 3, 1990.

Please transmit copies of the responses to Senator Heinz and to the Committee's publication office. If I can be of further assistance, please let me know.

Sincerely,

Robert N. Downey

Robert N. Downey
Chairman, Securities Industry
Association

4191p

NEW YORK OFFICE 120 Broadway, New York, N.Y. 10271 (212) 608-1500

Robert N. Downey, Chairman of the Securities Industry Association, subsequently submitted the following responses to written questions from Senator John Heinz in connection with the hearing held on April 3, 1990.

Q. 1. The banking and securities industries have apparently drawn different lessons from the savings and loan crisis. Mr. Labrecque testified on page 3 of his written testimony that limitations on the scope of thrift activities prevented meaningful diversification of assets which set the stage for disaster. Your written testimony on page 6, however, states that it was the ability of thrifts to use federally insured deposits to fund a wide array of activities that caused the savings and loan crisis. Is Mr. Labrecque correct when he states that a broadly diversified portfolio of assets is less risky than placing all of your eggs in one basket?

A. 1. Expanded bank powers should not be equated with diversification of risk. In the case of the savings and loan industry, for example, thrifts were permitted to "diversify" into speculative commercial real estate development, and thereby became increasingly vulnerable to economic downturns such as those that occurred in Texas. A comprehensive study by John Rickmeier in the S&L-Savings Bank Financial Quarterly found that thrifts that remained focused on their traditional business of lending to homeowners and declined to make risky loans survived the local recessions, while the thrifts that "diversified" contributed to a taxpayer tab that now approaches $500 billion by some counts. Similarly, banking organizations that desire the legal ability to engage in the full spectrum of securities and securities-related activities, including underwriting high-yield corporate bonds and equity securities and engaging in speculative foreign exchange transactions and transactions in commodities, may be diversifying their assets if such powers are granted, but would be increasing the overall riskiness and volatility of their assets. While a number of securities firms have managed to ride the roller-coaster of risk and volatility over the years without derailing, the failure in recent years of hundreds of securities firms, including giants such as Drexel and Hutton, should give more than a little pause to those who characterize entry into the securities business as a risk-reducing measure for commercial banks. Unless properly structured, an expansion of bank powers will simply increase the risk borne by the American taxpayer by adding to the federal safety net risk that is not subject to market forces. As observed by Federal Reserve Chairman Alan Greenspan in a speech delivered on May 10, 1990, "[o]ver and above the real taxpayer costs when supervision fails to constrain the worst excesses, the safety net distorts market signals, induces managers to take on risk that does not offer the possibility of commensurate economic benefits, requires supervisors and regulators to monitor and modify behavior induced by distorted market signals [and] increases borrowing by riskier firms...."

Q. 2. In your written testimony at page 7, you conclude that "retail" mortgage and consumer loans to individuals are examples of activities that merit funding by federally insured deposits. Indeed, the SIA proposal would permit a securities firm to own a "consumer" bank. Are bank portfolios confined to mortgage and consumer loans sufficiently diverse to limit risk to the deposit insurance system?

A. 2. Some of the nation's strongest banks, such as First Wachovia, have focused on retail banking rather than wholesale credit transactions. In addition, as indicated above, the thrifts that confined their credit activities to mortgage loans did better in the long term than their counterparts engaged in commercial transactions. Retail banking involves a greater number of transactions and borrowers than wholesale commercial banking and the transaction risk is therefore less concentrated. Furthermore, any analysis of risk borne by federally insured institutions must take into account the costs and benefits of such risks. Federally insured banks and thrifts which accept deposits from small savers are the primary, and often the only, source for consumer and residential mortgage loans; federal deposit insurance and other government support reduces the bank's cost of funds for such loans and increases the availability of such retail credit. By contrast, the private sector already provides securities underwriting services and other securities-related services without any need for government support. While there is a public policy justification for encouraging federally insured institutions to engage in retail lending, permitting underwriting and other wholesale securities and securities-related activities, and their attendant risks, within such institutions has no apparent justification, and, based on the savings and loan industry experience, can cause untold harm to the American taxpayer.

Q. 3. Some observers note that unless a financial institution has the authority to engage in activities that will enable it to earn a profit, it will not be able to attract the capital needed to protect the deposit insurance system. Will narrow consumer banks meet this test?

A. 3. As indicated above, banks that focus their business on consumer and other retail credit can be quite profitable. Profits may not reach the level of profitability that commercial banks engaged in wholesale commercial credit transactions may achieve in good years, but there is less downside exposure for consumer banks than there is for banks with charters that permit more speculative credit transactions. As the thrift industry situation demonstrates, achieving a proper balance of profitability and risk for federally insured institutions is crucial to the protection of the federal taxpayer. Federally insured consumer banks can be sufficiently profitable to attract investors interested in a moderate, steady return; investors seeking the types of returns associated with more entrepeneurial businesses should invest in non federally insured enterprises.

QUESTIONS FOR THOMAS LABRECQUE
FROM SENATOR JOHN HEINZ
HEARINGS ON FINANCIAL MODERNIZATION
APRIL 3, 1990

Q.1. The banking and securities industries have apparently drawn different lessons from the savings and loan crisis. You testified on page 3 of your written testimony that limitations on the scope of thrift activities prevented meaningful diversification of assets which set the stage for the disaster. Mr. Downey's written testimony on page 6, however, states that it was the ability of thrifts to use federally insured deposits to fund a wide array of activities that caused the savings and loan crisis. Can these two views by reconciled? If so, how?

A.1 What I said on page 3 of my written statement is this:

> The limited thrift charter only worked well under relatively stable economic conditions, regulated deposit rates, and less integrated financial markets. But the combination of investment restrictions with changing economic conditions proved fatal. When interest rates peaked in the early 1980s, nearly all thrifts found themselves insolvent on a market value basis as the value of their long-term fixed-rate portfolios plunged. The regulators responded to the problem by virtually dismantling thrift capital requirements, allowing many institutions to operate with little or no real capital. (Underlining added)

Contrary to the implication of Mr. Downey's comments, it was not expanded asset authority which caused the thrift crisis. The thrift crisis is the result of a near total collapse of thrift supervision and capital adequacy enforcement -- "desupervision" not "deregulation". With rigorous supervision and deposit insurance reform which includes an element of market discipline, expanding the product and service authorities for banking organizations will not pose undue risk to the deposit insurance fund.

Details regarding the deterioration of thrift institution supervision in the 1980s are provided in the attached report of the ABA FSLIC Oversight Committee. The attached report is an integral part of my response to this question, and I ask that the report be included in its entirety as part of my response.

Savings and Loan Association Regulatory Reform: Action Recommendations and Historical Perspective

A report by

The FSLIC Oversight Committee
of the
American Bankers Association

This paper has been prepared as part of the program of study and analysis being conducted by the FSLIC Oversight Committee of the American Bankers Association on the insolvency of the Federal Savings and Loan Insurance Corporation (FSLIC).

Savings and Loan Association Regulatory Reform: Action Recommendations and Historical Perspective

Table of Contents

Page

Action Recommendations 1

Overview 3

Findings of the ABA's FSLIC Oversight Committee 5

A History of Weak and Permissive Regulatory Oversight 5

Financial Soundness 6
Dismantling of Net Worth Requirements 6
Excessive Capital Forbearance 8
Misleading Liquidity Requirements 9
Inadequate Limits on Loans to One Borrower 10

Supervision and Examination 11
Mistaken Separation of Supervision and Examination 11
Conflicting Mandate to Promote Yet Regulate 12
Limited Scope of Examinations 13
Delays and Indecisiveness 13
Ineffectual Examinations 14
Deficient Incorporation Standards 14

Infrequent Use of Enforcement Actions 15

Permissive Accounting Standards 16

Lack of a Closure Policy 19

Tables

Example of the Impact of the Five-Year Deposit Averaging Scheme on Net Worth 21

Use of Enforcement Powers by the FHLBB 22

Graphs

Length of Insolvency of Insolvent S&Ls 24

Thrift Regulatory Staff and Industry Assets 25

FSLIC Oversight Committee Members 27

Savings and Loan Association Regulatory Reform

Action Recommendations

In its initial report in September 1988 entitled The FSLIC Crisis: Principles and Issues. A Call to Action, the FSLIC Oversight Committee of the American Bankers Association set forth a three-phase action plan to resolve the crisis in the savings and loan association (S&L) industry. Immediate actions called for a halt to the growth of insolvent and nearly-insolvent FSLIC-insured institutions. Near-term actions called for documentation of regulatory, supervisory and accounting deficiencies in the S&L industry, and development of a framework for increasing the pace of bankrupt S&L case resolutions. Longer-term actions called for the 101st Congress to enact legislation to bring S&L industry regulatory, supervisory, and accounting standards up to banking industry levels, require a substantial increase in the pace of insolvent S&L liquidations, and provide a sound means for funding the case resolution process.

This paper focuses specifically on reforms in S&L regulation and supervision. While steps have been taken by the Federal Home Loan Bank Board (FHLBB) to improve the regulation, supervision, examination, and accounting procedures of FSLIC-insured S&Ls, they must be viewed against the backdrop of weak supervision and regulation for more than two decades. To ensure that the crisis does not recur, there must be a commitment to adequate capitalization of FSLIC-insured institutions and effective supervision by Congress, S&L regulators, and the S&L industry. To help ensure that reforms which have been made and those yet to be made are enduring, clear review and accountability procedures must be established. The public and Congress must be informed periodically and systematically about the progress being made for full implementation of corrective actions.

Upon review of a number of specific failures in S&L regulation, supervision, examination, enforcement, and accounting standards, the American Bankers Association offers the following recommendations:

- **The statutory mandate of the FHLBB should be revised so that its regulatory role is focused solely on ensuring the safe and sound operation of the institutions under its jurisdiction.** Any statutory language promoting housing should be confined to the advance program of the Federal Home Loan Bank System.

- **Accountability for effective regulation and supervision of FSLIC-insured institutions should be established.**

  - The FHLBB should publish and annually update a detailed three-year plan for strengthening its regulation and supervision.

  - The Federal Financial Institutions Examinations Council should establish quality-control standards and review mechanisms.

  - Congress should annually hold oversight hearings on the appropriateness of the FHLBB's plans and how well the FHLBB has met its goals.

  - The U. S. General Accounting Office should continue to test for compliance with statutory requirements, and good management and accounting standards.

- **Supervision and examination of FSLIC-insured institutions should be integrated.**

- **Capital standards no less rigorous than those applied to commercial banks should be adopted immediately.** Supervisory agreements setting specific targets for improvement of net worth positions and imposing restrictions on bonuses, certain expenses, dividends, borrowings, and rates paid on deposits should be used for those FSLIC-insured institutions unable to meet bank capital standards. Additional enforcement actions should be used to ensure compliance with these agreements.

- **Congress should direct the FHLBB to eliminate any remaining elements of Regulatory Accounting Principles.** Such action will prevent overstatement of net worth positions under the current five-year phase out of such elements.

- **The statutory provision establishing a liquidity requirement for FSLIC-insured institutions should be eliminated and replaced by a provision establishing a net liquidity measure as required for FDIC-insured institutions.** The existing statutory requirement, which compares liquid assets to total deposits and short-term borrowings, is misleading. A liquidity requirement should be based upon net liquidity in which certain types of short-term deposits and liabilities are subtracted from liquid assets.

- **FSLIC-insured institutions should be subject to the same statutory limitations on loans to one borrower and concentrations of credit as those imposed by bank regulatory agencies on banks.**

- **The FHLBB should adopt the same policies and procedures as those of bank regulators in closing institutions that become insolvent.**

- **The FHLBB should adopt the same approach and standards as the bank regulatory agencies in considering incorporations of new institutions and changes in control.**

Savings and Loan Association Regulatory Reform

An Overview

The FHLBB has recently begun to take some positive steps toward more effective regulation and supervision. In particular, the FHLBB has brought S&L net worth requirements closer to bank capital standards, improved examiner training, increased the number of examiners, and streamlined procedures for enforcement actions.

Congress has also initiated many improvements. In response to the Competitive Equality Banking Act of 1987 (CEBA), the FHLBB adopted appraisal standards and asset classification systems consistent with those of federal bank regulatory agencies, and has taken steps to phase in over a five-year period generally accepted accounting principles for FSLIC-insured institutions.

Unfortunately, the effectiveness of these recent actions continues to be undermined by the existence of hundreds of insolvent, yet operating FSLIC-insured institutions. Regulatory and supervisory reforms can only be effective when combined with a strong and swift closure policy. Without it, bankrupt and thinly-capitalized S&Ls will have the incentive to continue high-risk strategies. In addition, the ability to regulate healthy S&Ls will be undermined as these institutions will see little value in abiding by costly regulations that do not apply equally to all institutions.

Combined with an effective closure policy, the recent actions have promise. As the action recommendations presented in section I indicate, however, much more needs to be done. Perhaps the greatest obstacle that must be overcome is the perception that the FHLBB lacks the will to discard past practices and move decisively in promoting and implementing new policies and actions. A review of past practices creates deep concerns about the ease with which this obstacle can be overcome.

The failure of regulation and supervision is nowhere more evident than in the deterioration of net worth positions of FSLIC-insured institutions during the 1970s and early 1980s. During this time, net worth requirements in the S&L industry were effectively dismantled. Until 1971, FSLIC-insured institutions were required to have net worth equal to five percent of year-end deposits. The FHLBB substantially weakened this requirement and encouraged rapid deposit growth by allowing net worth to be calculated relative to the average of year-end deposits over the previous five years. In 1980, Congress gave the FHLBB power to vary the net worth requirement between three percent and six percent. While retaining the five-year averaging procedure, the FHLBB quickly moved to reduce the requirement to four percent in October 1980 and to three percent in December 1981. Most S&Ls were thus relieved from any constraint of net worth requirements on deposit and asset growth for at least several years. It was an open invitation for reckless expansion.

Financial soundness was further diminished by other deficiencies in regulation such as the degree of "forbearance" extended to FSLIC-insured institutions with net worth positions well below the minimum requirement, inadequate and misleading liquidity requirements; high loan-to-deposit ratios, high loan-to-value ratios, and overstated property appraisals.

Besides the weaknesses of financial soundness regulation, there were serious deficiencies in the supervision and examination of FSLIC-insured institutions during the early 1980s. The fact is that an adequate and appropriate regime for supervision and examination of S&Ls did not exist at the beginning of the 1980s.

The root of the problem is that the charter of the FHLBB and FSLIC, drafted in the early 1930s, deliberately maintained supervision and examination as separate and distinct activities within the Federal Home Loan Bank System. Supervision of FSLIC-insured institutions was the responsibility of Federal Home Loan Banks (FHL Banks) while examinations were controlled and administered by the FHLBB in Washington, D.C. This separation limited the power of examiners, created delays and indecisiveness, and allowed many troubled institutions to continue business as usual.

The problem was exacerbated by the limited scope of examinations, which emphasized discovery of technical violations of laws and regulations rather than loan quality and the reasonableness of appraisals. The limited scope was in part a result of inadequate staffing and training of field examiners.

Effective supervision and regulation were also constrained by conflicting objectives resulting from the statutory mandate of the FHLBB and district Banks to promote homeownership through home financing. This mandate also made supervision and examination of S&Ls too accessible to interference from the industry and its political allies.

Impeded by these structural and organizational weaknesses, little use was made of enforcement actions such as supervisory agreements, cease and desist orders, and civil money penalties. The rare use was, in part, an outgrowth of misguided FHLBB leadership in the early 1980s which apparently believed that the industry needed less, not more, supervision.

Perhaps the most obvious attempts to paper over the developing problems in the S&L industry were the concessions in accounting standards made in 1980 and 1981. These concessions -- including issuance of income capital certificates, deferral and amortization of losses on sales, special treatment of merger and acquisition premiums to allow long-term amortization of goodwill, and adjustment of net worth to reflect increases in appraised values of premises and related real estate -- enabled FSLIC-insured institutions to show a higher net worth than would otherwise have been the case.

While these accounting concessions were intended to allow S&Ls to "buy time" to "get back on their feet" after the 1979-1981 upswing in interest rates, for some institutions the reprieve served no purpose but to disguise their insolvency which would have been obvious under appropriate accounting standards. Since these insolvent S&Ls were allowed to continue in operation, the accounting reprieve served mainly to allow the launching of speculative expansion plans.

In summary, the dismantling of net worth requirements and other regulatory deficiencies had serious adverse effects on the financial soundness of hundreds of FSLIC-insured institutions throughout the 1970s and early 1980s. Supervision and examination, long burdened by statutory provisions limiting their effectiveness, were grossly inadequate to respond to the challenges facing the S&L industry in the early 1980s. The regulatory authorities turned away from enforcement actions at the very time that their use might have done the most good. Through forbearance policies and accounting concessions, failed and failing institutions were allowed time to compound the extent of their insolvencies. Lack of a meaningful policy to close bankrupt S&Ls only increased the ultimate cost of resolving the problem.

Against this institutional history it is reasonable to express concern whether effective regulation and supervision will really be enduring in the S&L industry. There is a clear need for continuing interest in and close monitoring of improvements. It is in response to that need that the recommendations by the American Bankers Association are made.

Savings and Loan Association Regulatory Reform

Findings of the ABA's FSLIC Oversight Committee: A History of Weak and Permissive Regulatory Oversight

One conclusion reached by the FSLIC Oversight Committee in its September 1988 report was that the FSLIC's insolvency was largely the result of deficiencies in the regulation and supervision of S&Ls. Since early 1987, recognition of deficiencies prompted the FHLBB to initiate a number of changes to improve the regulation, supervision, examination, and accounting practices of FSLIC-insured institutions. In the CEBA, Congress also sought to remedy certain weaknesses. The primary actions are listed below:

- Net worth regulation has been strengthened. In a regulation first issued in January 1985 and substantially revised in August 1986, the FHLBB set a general net worth requirement equal to six percent of assets, with certain phase-in arrangements for low net worth S&Ls. CEBA authorized the FHLBB to establish case-by-case net worth requirements for individual institutions and required the FHLBB, over time, to bring capital requirements for FSLIC-insured institutions into conformity with capital requirements for FDIC-insured banks. The FHLBB has released for public comment an "asset-based," or "risk-based," approach to capital requirements.

- CEBA required that the FHLBB adopt appraisal standards consistent with those of the federal bank regulatory agencies. A regulation implementing that requirement was finalized in December 1987.

- Classification standards and procedures for evaluation of loans and other assets by examiners adopted in December 1985 provoked considerable controversy, but CEBA strengthened the hand of the FHLBB, Federal Home Loan Banks, and examiners by requiring adoption of a classification of assets system consistent with that of the federal bank regulatory agencies. The regulation was adopted in December 1987.

- The FHLBB has taken several steps to bring direct investments under close supervision and control. The approach has been to impose the same diversification standards on direct investments as on loans.

- The FHLBB has sought to streamline procedures for taking formal supervisory actions and to make clear to the managements of all FSLIC-insured institutions the circumstances under which such actions will be taken.

- The number of persons employed in examination and supervision has been substantially increased, salaries have been increased, and new emphasis is being placed on training.

While constructive, these changes must be viewed against a long history of weak regulatory and supervisory practices by the FHLBB and FSLIC. The deficiencies leading to S&L failures and the FSLIC's bankruptcy were not lapses from standards that had previously been adequate. In fact, numerous compromises and concessions were made in regulatory, supervisory, and accounting standards for FSLIC-insured institutions during the 1960s and 1970s. While these compromises were usually rationalized as necessary to meet the "housing mandate" of the S&L industry, they had serious adverse effects on the soundness of many S&Ls and the integrity of the supervisory framework.

The recent changes must also be viewed against the hundreds of insolvent FSLIC-insured institutions that continue to operate. Changes in regulation and supervision have served little or no value in altering incentives of bankrupt and thinly-capitalized S&Ls to pursue high-risk strategies. Only rapid closure of bankrupt S&Ls would serve this purpose.

To understand the significance of these changes and demonstrate the need for close monitoring to ensure that they are effective and enduring, it is important to review past deficiencies in S&L financial soundness regulation, supervision and examination, enforcement action usage, and accounting standards.

Financial Soundness

Regulation and supervision are dedicated to ensuring that financial institutions act in accordance with safe and sound practices. The experience of S&L regulation and supervision suggests that serious lapses occurred in carrying out this responsibility. On the regulatory side, this failure was evident in setting and administering net worth requirements, capital forbearance policies, and liquidity requirements. The differences in financial soundness standards between FDIC-insured commercial banks and FSLIC-insured S&Ls help explain why S&Ls were more vulnerable to failure in the 1980s. The following summarizes the differences:

- Lower capital/net worth requirements meant that FSLIC-insured S&Ls had relatively smaller amounts of net assets, or solvency "cushions," to cover loan and operating losses than FDIC-insured banks.
- Greater "forbearance" allowed a large number of S&Ls to fall deeper and deeper into negative net worth positions, compounding the FSLIC's losses.
- Higher loan-to-deposit ratios allowed FSLIC-insured S&Ls to take on significantly greater risk exposure than FDIC-insured banks.
- Higher limits on loans to one borrower for FSLIC-insured S&Ls than for FDIC-insured banks helped foster concentrations of speculative loans.

Dismantling of Net Worth Requirements

The legacy of compromises and concessions made in the two decades before 1980 is nowhere more evident than in the widespread weakness in net worth positions of FSLIC-insured institutions that developed during the 1970s and led to widespread failures in the 1980s.

When Congress delegated broad authority to the FHLBB to charter and regulate federal savings and loan associations in Section 5 of the Home Owners Loan Act of 1933, no mention was made of any kind of net worth or capital adequacy requirement as we know it today. Such an omission was inherent in the structure of savings and loan associations at that time. Savings accounts in an association were shares, not deposits. In fact, Section 5(b) of the 1933 Act barred the taking of deposits. The savings, or share, accounts were the capital of a savings and loan association, and account holders had the status of shareholders, not depositors. The amount by which total assets of an association exceeded total liabilities and share accounts was denoted as "surplus" or "reserves" (for loan losses).

The Housing Act of 1934, which established the FSLIC, provided for insured savings and loan associations to accumulate and maintain a "Federal Insurance Reserve" (FIR) equal to five percent of total share accounts. The Act established a phase-in period of ten years for newly chartered institutions; because federal chartering had been initiated only in 1933, a large number of institutions qualified for the phase-in period. Several years later the statute was amended to extend the phase-in period to twenty years. The net worth requirements for FSLIC-insured institutions today are descendants of the FIR requirement enacted in 1934.

The Housing Act of 1968 deleted the restriction in the Home Owners Loan Act of 1933 that barred federally-chartered S&Ls from accepting deposits. Similar legislative changes had been made in various states, beginning in the late 1950s. Shareholders became depositors (creditors), and what had been the capital of savings and loan associations became liabilities (deposits). This was a fundamental change in financial structure. It clearly required, at a minimum, significant strengthening of the FIR, or net worth, requirement and preferably the articulation of a whole new standard of capital adequacy.

The FHLBB did make an attempt in 1972 to strengthen enforcement of the FIR requirement and to impose supplemental net worth requirements based on an institution's risk exposure. The S&L industry not only beat back this attempt at tighter regulation by the FHLBB, but obtained new concessions by appealing to Congress. The FIR phase-in period was extended from twenty to twenty-five years by Congress, and even more importantly, the FHLBB issued a new regulation permitting S&Ls to average year-end deposit balances over the past five years to compute the statutory net worth requirement for the current year.

The S&L industry went back to Congress in 1979 to ask for a reduction in the statutory net worth requirement from five to four percent. The FHLBB went even further and requested of Congress authority to vary the requirement between three and six percent. Such authority was granted in the Depository Institutions Deregulation and Monetary Control Act of 1980 and the FHLBB proceeded to reduce the statutory net worth requirement to four percent in October 1980 and to three percent in December 1981.

The dismantling of net worth requirements during the 1972-1982 period was the single most important factor contributing to the wave of S&L failures after 1982. The "five-year averaging" regulation should probably be regarded as the single most disastrous move ever made by a regulatory agency with respect to capital adequacy. Combined with the three percent net worth standard established in December 1981, it provided a powerful incentive for aggressive expansion.

To illustrate this point, suppose that an S&L had a five-year growth pattern as shown in the example in Table 1. By the end of 1981, its net worth requirement would have been $3.60 million or 2.6 percent of year-end 1981 deposits. Expansion of deposits by fifty percent over the next year would have increased the dollar amount of the net worth requirement to $4.26 million, dropping the ratio of required net worth to year-end deposits to 2.0 percent. On the 1982 increase of $70,000,000 in deposits, the incremental net worth requirement would have been $660,000 -- only 92 basis points.

Without meaningful restraints, growth of deposits and assets of FSLIC-insured institutions surged in 1982-1984. By early 1984, the FHLBB proposed changes in net worth requirements aimed at slowing the rapid pace of S&L expansion, including elimination of the five-year averaging method. But industry opposition again prevailed and the proposal was suppressed. It was not until January 1985 that the deteriorating condition of large numbers of S&Ls and the dwindling resources of the FSLIC caused sufficient concern within the industry to support an upward revision in net worth requirements.

In August 1986, the FHLBB set forth a "three step" approach to determination of net worth requirements:

1) A basic "liability component" required a thrift institution to have net worth equal to six percent of liabilities. Growth in liabilities had to be supported immediately at six percent. A phase-in process was provided for institutions unable to meet the six percent requirement on existing liabilities.

2) A "contingency component" increased the net worth requirement by specific percentages according to designated types of risky and scheduled assets.

3) A "maturity matching credit component" allowed institutions to reduce net worth requirements below six percent by having one-year and three-year hedged maturity gaps in selected ranges. By keeping such gaps below fifteen percent absolute value, an institution could reduce its net worth requirement to as low as three percent of liabilities through August 1989, and to four percent thereafter.

CEBA authorized the FHLBB to modify net worth requirements for individual institutions as necessary in the light of circumstances affecting that institution. The promulgation of the law by the FHLBB occurred in December 1987. With minor changes, the "three step" calculation established in August 1986 continued in effect.

The foregoing review of changes in net worth requirements for FSLIC-insured S&Ls is a disturbing story. Congress and the FHLBB, responding to pressures from the S&L industry, systematically and decisively dismantled net worth requirements between 1972 and 1982. By the time an attempt was made to restore some semblance of effective requirements in January 1985, insolvency was already epidemic.

Excessive Capital Forbearance

Another dimension of the problem of inappropriate regulation of net worth positions has been the degree of "forbearance" extended in 1982 and 1983 to FSLIC-insured institutions with net worth positions below the minimum requirement. Since its inception in 1934, the FSLIC has had broader discretionary authority than the FDIC to assist troubled institutions. Though the FDIC's discretionary authority has recently been expanded, the FSLIC still appears to have more flexibility.[1]

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[1] The broad authority of the FSLIC is a vestige of the structure of savings and loan associations at the time of passage of the Housing Act of 1934. As discussed above, savings accounts were not deposits but were the "share capital" of savings and loan associations. The inability of an association to honor a request for withdrawal of funds from a savings account did not constitute default. The owner of the savings account, or "share capital," could be required to wait until the association had funds in hand to honor the withdrawal request. Under FSLIC policy and practice, "default" did not occur until an association was placed in receivership. The conferring of deposit status on
(Footnote Continued)

The forbearance actions of the early 1980s are summarized in the following quotation from Where Deregulation Went Wrong, written by Norman Strunk and Fred E. Case and published by the U. S. League of Savings Institutions in 1988:

> The response of the business [S&L industry] to its net worth problems in 1982 and 1983 was to ask, in addition to lowering of the net worth requirements to three percent, for forbearance on enforcing even that low benchmark, and net worth assistance in the form of income capital certificates first provided by administrative action of the Board, and later by the Garn-St Germain Act.
>
> The Board responded with a variety of ameliorating provisions. These included the creation of goodwill assets from supervisory-induced mergers, which initially could be amortized up to 40 years [now 25 years], appraised equity capital from revaluing the business' fixed assets, and a new regulation permitting the deferral of losses on loan sales.[2]

Under the net worth certificate program, assistance was available to institutions with net worth as low as 0.5 percent of assets, based on Regulatory Accounting Principles (RAP). On the basis of generally accepted accounting principles (GAAP), many of these S&Ls would have had negative net worth. Moreover, on a tangible net worth basis, which is closer than GAAP to the accounting principles used in determining the net worth of commercial banks, a significant number of FSLIC-insured institutions were insolvent by late 1982 or early 1983 (see Graph 1). Thus, extensive use of forbearance for institutions that were barely solvent on the most lenient accounting basis acted only to delay resolution of problem cases, ultimately at a much greater cost.

Capital standards no less rigorous than those applied to commercial banks should be adopted immediately for S&Ls. Supervisory agreements setting specific targets for improvement of net worth positions and imposing restrictions on bonuses, certain expenses, dividends, borrowings, and rates paid on deposits should be used for those S&Ls unable to meet bank capital standards. Additional enforcement actions should be used to ensure compliance with these agreements.

Misleading Liquidity Requirements

Misleading liquidity requirements were another aspect of regulatory policy affecting the financial soundness of FSLIC-insured institutions. In this case, inappropriate regulatory policy in the 1980s was not reflected so much in reductions in liquidity requirements as in policy changes that allowed S&Ls to increase their reliance on short-term borrowings without reflecting this trend in measures of liquidity.

The FHLBB was given authority in 1950 to set liquidity requirements in a range between four and eight percent of an S&L's savings deposits. Cash,

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(Footnote Continued)
such savings accounts, as effected at the state level beginning in 1958 and at the federal level in 1968, obligated institutions to honor withdrawal requests when made but did not alter the FSLIC's policy and practice that an institution was not in default until placed in receivership. The FSLIC thus assumed a very large burden to protect depositors in insured S&Ls.

[2] Strunk, Norman and Fred Case. Where Deregulation Went Wrong: A Look at the Causes Behind Savings and Loan Failures in the 1980's. United States League of Savings Institutions, 1988, Page 37.

deposits at FHL Banks, and U. S. Treasury securities were designated as eligible assets for the liquidity requirement. Subsequent statutory changes broadened the range from four to ten percent; expanded the types of eligible assets to include bank deposits, federal agency issues, and certain state and local government obligations; and expanded the base for calculation of the requirement to include total deposits plus short-term borrowings.

Since the early 1980s, borrowings by FSLIC-insured institutions -- from FHL Banks and other financial institutions -- have increased more rapidly than their holdings of liquid assets. At the end of 1987, borrowings exceeded liquid assets for the industry as a whole. This "negative gap" would be even wider if large certificates of deposits were counted as borrowings.

Thus, the net liquidity of the industry was negative even though liquid assets were in excess of ten percent of total of deposits and short-term borrowings. Meeting the existing requirement gives the impression that an institution's liquidity is adequate when in fact the institution may owe more in short-term borrowings than it has in liquid assets. In reality, the liquidity of FSLIC-insured institutions today is almost totally dependent on the FHL Banks.

The statutory provision establishing a liquidity requirement for FSLIC-insured institutions should be eliminated and replaced by a provision establishing a net liquidity measure in which certain types of short-term deposits and liabilities are subtracted from liquid assets.

Inadequate Limits on Loans to One Borrower

National banks are allowed to make unsecured loans to one borrower up to fifteen percent, and well-secured loans up to twenty-five percent, of the bank's capital and surplus. An S&L, on the other hand, can loan 100 percent of its net worth to any borrower. This has led to loan concentrations in many S&Ls, increasing the risk to the institution. Moreover, this risks was exacerbated in many S&Ls due to the highly speculative nature of many of these loans.

The FHLBB has recognized that excessive loans to one borrower have contributed to major losses at and eventual failure of a number of S&Ls. While the FHLBB has considered making S&L loan limits consistent with bank limits, no final action has been taken. In view of the credit loss experience of so many floundering S&Ls, adoption of bank loan limits, together with the same vigorous enforcement facing banks, is needed.

Inadequate limits were also reflected in high loan-to-deposit ratios permitted of FSLIC-insured institutions. In the early 1980s the FHLBB encouraged S&Ls to expand loans and accept higher loan-to-deposit ratios (sometimes in excess of one hundred percent). High loan-deposit ratios may have been acceptable when the savings accounts were "share capital" and could be regarded as relatively long-term placements of funds by individuals and households. However, the interests of safety and soundness of the financial system would have been better served by lower loan-deposit ratios when savings accounts became deposits and rate competition for deposit funds intensified. Clearly, lower loan-to-deposit standards, appropriate to modern deposit liquidity, should be established.

Supervision and Examination

In addition to failures of regulation which led to a deterioration of financial soundness in FSLIC-insured institutions, there was also a failure in the supervision and examination process:

- Separation of supervision and examination in the Federal Home Loan Bank System (FHLB System) was a serious impediment to effectiveness in supervision and examination.
- Supervision was afflicted by delays and indecisiveness.
- Examinations, even after their scope was broadened in the latter 1960s, continued to be more oriented to detection of violations of laws and regulations than to the quality of assets and the soundness of institutions.
- The examination function in the FHLB System was understaffed, underpaid, and under-trained.
- As a result of the promotional aspects of the FHLBB's "housing mandate," supervision and examination of S&Ls have been too often constrained by conflicting objectives and have been too accessible to interference from the industry and its political allies.
- The shift of the examination staff from the FHLBB to the FHL Banks was an expedient dictated by unreasonable and unrealistic restrictions imposed by the Office of Management and Budget. While the move was beneficial and necessary, a conflict of interest may still prevail since the Boards of Directors of the FHL Banks are composed primarily of officers of insured thrift institutions in the respective districts.

Mistaken Separation of Supervision and Examination

Until July 6, 1985, federal supervision and examination of FSLIC-insured institutions were deliberately maintained as separate and distinct activities. On one hand, supervision was the responsibility of the district FHL Banks. Each of the twelve district Bank presidents is, by statute, the "Principal Supervisory Agent" in his district. Considerable power and authority for supervision of insured S&Ls are thus held by each president. Potential conflicts may arise since the president of each district Bank is elected by the Bank's board of directors, a majority of which are officers of insured S&Ls in that district.

On the other hand, examination of FSLIC-insured institutions (prior to July 6, 1985) was controlled and administered by the FHLBB staff in Washington, D.C. under a Director of Examinations and Supervision appointed by the FHLBB. The 1980 Annual Report of the FHLBB described the separation of the operations of the Office of Examinations and Supervision (OES) from the examinations staff as follows:

> Through a field staff of approximately 900 examiners and support staff, OES conducts on site examinations of [insured] institutions to determine their financial safety and soundness and their compliance with federal statutes and Bank Board regulations. **OES's Washington-based Supervision staff reviews reports of these examinations to determine the necessity of corrective supervisory action** in coordination with

> supervisory agents in the 12 Federal Home Loan Banks, the FSLIC staff, and, as necessary, counterpart state regulatory agencies in the case of state-chartered institutions.[3] [Emphasis added]

The deliberate separation of supervision from examination in the FHLB System was encouraged by the S&L industry. Strunk and Case, in the work cited above, state that in the 1930s the U. S. Building and Loan League (grandfather of the current-day U. S. League of Savings Institutions) did not want S&L examiners to have as much power as bank examiners because "many banks closed by [bank] examiners should not have been closed."[4] Further:

> For generations the savings and loan business has been wary of examiners and supervisors. The business has tried to keep examination costs and supervision to a minimum, possibly because its early leadership distrusted the whole supervisory process.[5]

The U. S. Building and Loan League believed that:

> Too much discretion had been given the field examiners to decide the quality of bank assets and hence their solvency. In contrast to the bank supervisory apparatus, this led to the separation of the examination and supervisory functions in the organization of the Bank Board and a detailed regulatory system for the savings and loan business which was not fundamentally altered until 1986.[6]

The reference to "detailed regulatory system" is significant. It means that: 1) the federal and state rules and restrictions affecting FSLIC-insured institutions should be specifically set forth in laws and regulations; 2) that examiners should test only for compliance with the rules and restrictions set forth in laws and regulations; and 3) that the managements of FSLIC-insured institutions should be allowed to conduct their business as they pleased so long as they are in technical compliance with the specific provisions of applicable laws and regulations. This was the view that dominated supervision and examination in the FHLB System until the mid-1980s and may still dominate industry views about supervision and examination.

Supervision and examination of FSLIC-insured institutions should be coordinated and integrated; recognition of problems should be closely linked to remedial actions.

Conflicting Mandate to Promote Yet Regulate

In addition to the separation of supervision from examination and close containment of discretionary authority, supervision and examination in the FHLB System were constrained by the System's "statutory mandate" to promote homeownership through home financing. The FHLBB apparently interpreted that "mandate" as an obligation to be the S&L industry's advocate with Congress and the public.

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[3] Federal Home Loan Bank Board, Annual Report, 1980, page 39.

[4] Ibid., page 18.

[5] Ibid., page 114.

[6] Ibid., page 18.

The statutory mandate of the FHLBB should be revised so that its regulatory role is focused solely on ensuring the safe and sound operation of the institutions under its jurisdiction. Any statutory language promoting housing should be confined to the advance program of the FHLB System.

Limited Scope of Examinations

Until the late 1970s, examinations of FSLIC-insured institutions were directed more to discovery of violations of laws and regulations than to evaluation of the quality of loans and investments, and the institution's safety and soundness. In fact, it was not until the late 1960s that the scope of examinations included regular reviews of loan quality and the reasonableness of appraisals. Moreover, the FHLBB was slow in instituting appropriate guidelines for such reviews and developing relevant training programs for examiners. The lack of sophistication in early attempts to conduct reviews of loans and appraisals served to confirm the long standing industry opinion that examiners could not be trusted to make proper evaluations of loan and appraisal activities.

The limited scope of examinations was also reflected in high loan-to-value ratios. High ratios have been a problem in the S&L industry since the first "no, no, no downpayment" home mortgage loans were introduced in California in the 1950s. The problem was exacerbated in the 1980s by overly generous property appraisals. Many recent S&L failures have been attributed to faulty documentation and appraisal standards. Assuming realistic appraisals and borrowers with acceptable credit standings, high loan-to-value ratios can be tolerated in home mortgage lending. However, in lending for real estate development, commercial real estate, and commercial and industrial activities in general, high loan-to-value ratios have long been recognized as involving more than ordinary exposure to default risk. Defaults have left FSLIC-insured institutions now holding over $26 billion of foreclosed real estate.

By the late 1970s, the FHLBB finally began serious training of its examiners to evaluate the financial soundness of insured institutions. Recent improvements in training have also been initiated. In light of the recent real estate problems for S&Ls, the FHLBB must monitor appraisal procedures and loan-to-value ratios more closely for the institutions it oversees.

Delays and Indecisiveness

It is widely acknowledged within the S&L industry that the processes of examination and supervision in the FHLB System have been seriously afflicted by delays and indecisiveness. In an extensive review of the industry in 1969 (sponsored by the FHL Banks), Irwin Friend found that supervisory officials were indecisive in dealing with problem situations and that deliberations, involving FHL Bank staff in a district and FHLBB staff in Washington, took inordinately long periods of time.[7]

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[7] Friend, Irwin, ed., Study of the Savings and Loan Industry, vols. I-IV, Federal Home Loan Bank Board, Washington, D. C. 1969.

A study by the U. S. General Accounting Office (GAO) in 1981[8] also found delays and indecisiveness. "Total processing time from the date of the association's net worth failure to execution of the [supervisory] agreement ranged from five to 29 months for the fifteen agreements which were executed. The average time was 12.5 months." The GAO emphasized: "Indecisiveness contributes to time delays," and proceeded to describe a case in which FHLBB staff in Washington and FHL Bank staff in a district took "20 months to work out differences between themselves and with an insolvent association's management as to the content and form of a supervisory agreement."

Annual reports of the FHLBB during the 1980s indicate concern with a need to "streamline" administrative processes.

Ineffectual Examinations

The field examination staff of the FHLBB included 815 persons in 1976, an increase of only sixty over the 1966 staff. Over the same time period, total assets tripled ($133.8 billion to $390.4 billion), and S&L operations became more complex. Even assuming that the 755 persons in 1966 were sufficient in number to administer and conduct the limited-scope examinations of that time, it would be ludicrous to think that a staff of 815 was adequate to conduct examinations of wider-scope in 1976.

A similar pattern was observed between 1976 and 1985. The size of the field examination staff stayed nearly constant (being closely constrained especially after 1978) while the industry assets grew to over $1 trillion (see Graph 2).

FHLBB examiners were transferred from the FHLBB to the FHL Banks on July 6, 1985. The purpose of the move was to escape the constraints on salaries and hiring of the Office of Management and Budget. At that time, 747 of the total field examination staff of 897 were listed as examiners. By the end of October 1987, the number of examiners had been increased to 1,424.

The shift of examiners from the FHLBB to the FHL Banks not only facilitated a much-needed increase in the number of examiners but also a much-needed increase in salary levels. Before the move the entry-level salary of examiners at the FHLBB was $3,360 below the entry-level salary for FDIC examiners, and the average salary of FHLBB examiners was $7,730 below the average salary of examiners at the FDIC. Those differentials were quickly eliminated after the transfer of FHLBB examiners to the district banks.

Deficient Incorporation Standards

Lax regulation and supervision of FSLIC-insured institutions had another important consequence: they encouraged incompetent and unscrupulous individuals to either charter a new S&L or take over an existing one. Since current regulations permit an S&L to be organized by only one person, and given the laxity of oversight, individuals were afforded opportunities to use insured deposits in reckless, and in many cases criminal, ways. Recent reports state that fraud and insider abuse were present in 168 of 210 S&L insolvencies since 1984, representing millions of dollars of losses.

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[8] U. S. General Accounting Office. Formal Supervisory Process for Savings and Loan Associations should be Strengthened, September 17, 1981.

Clearly, tighter controls must be established to assure that insured S&Ls are operated by competent persons of high integrity. The FHLBB should adopt the same approach and standards as the bank regulatory agencies in considering changes in control and de novo incorporations.

Infrequent Use of Enforcement Actions

Regulators can use enforcement actions, including removal of officers, to halt unsafe and unsound practices. Once again, this tool was used ineffectively by the FHLBB:

- The use of enforcement actions by the FHLBB was impeded by structural and organizational weaknesses, especially the separation of supervision and examination.
- The use of enforcement actions was suppressed in the late 1970s and early 1980s, reflecting significant opposition from the industry and the distaste of FHLBB members for such actions.
- In the period 1983-1985, the FHLBB was slow in recognizing that enforcement actions could be used effectively to correct many of the problems causing insolvencies.
- Lack of experience in the use of enforcement actions as well as flawed fact-finding and decision-making procedures hampered the effectiveness of the FHLBB when it established an Office of Enforcement and began to try to make more aggressive use of enforcement actions in November 1985.

Several types of enforcement actions are available to the FHLBB, reflecting provisions of the Home Owners Loan Act of 1933, the National Housing Act of 1934, the Financial Institutions Supervisory Act of 1966, and the Financial Institutions Regulatory and Interest Rate Control Act of 1978. The available actions include supervisory agreements, cease and desist orders, civil money penalties, removal of officers, formal investigations, and termination of insurance.

The FHLBB reduced its use of enforcement actions in 1978-1980 and limited use of such actions in the period 1981-1983 (see Table 2). In its 1981 study, Formal Supervisory Process for Savings and Loan Associations Should Be Strengthened, the GAO found that this coincided with an increase in S&Ls on the FHLBB's problem list. The GAO noted that these "problem" institutions presented opportunities for use of enforcement actions. "Although not all institutions on the FHLBB's problem list have problems which can be corrected by initial formal action, our analysis...shows that most institutions on the December 3, 1979 list had problems that can be corrected by formal supervisory actions."[9]

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[9] The GAO found that of the 79 cases then on the FHLBB's problem list, 55 (two thirds) were strictly safety and soundness problems. Of the remaining 28 cases, 25 involved safety and soundness as well as regulatory violations. Of the 122 institutions on the list at January 31, 1981, 70 were new additions. All 70 involved safety and soundness issues, and 59 (or 84 percent) were strictly safety and soundness problems.

The GAO found that 55 (65 percent) of the 85 cases in which formal actions (Footnote Continued)

The use of enforcement actions is often complicated by procedures that must be followed to assure due process and to protect banks and individuals against disclosure of confidential information. Such complications, however, were not the reason for the limited use of enforcement actions by FHLBB during the late 1970s and early 1980s. Three reasons are readily apparent:

- The FHLBB's use of enforcement actions was seriously impeded by bureaucratic delays and indecisiveness;[10]
- The limited scope of examinations, inadequate training of examiners, and separation of examination and supervision were significant barriers to the timely discovery and necessary documentation of problems susceptible to correction through enforcement actions; and
- Misguided FHLBB leadership believed that the industry needed less, not more, supervision.[11]

In general, the use of "informal" actions, i.e., oral and written persuasion, is a preferred method to bring managements into line with applicable laws and regulations or to halt unsafe and unsound practices. Reliance on informal approaches has a long history in the supervision of banks. However, bank examiners have been very much involved in most "informal" actions whereas FHLB System examiners were limited to the role of "fact finders." The effectiveness of "informal" actions in banking has benefitted from the ability of examiners to obtain compliance "on the spot" at the time a violation or unsafe and unsound practice is detected.

Permissive Accounting Standards

Perhaps the most striking example of regulatory attempts to paper over the problems was the use of permissive regulatory accounting standards. This had the important consequence of delaying action on the large and growing number of insolvencies that were painfully obvious under generally accepted accounting principles and on a tangible capital basis. Other consequences are evident as well:

- The net worth of the S&L industry continues to be overstated -- by a relatively significant amount -- due to accounting concessions made by the FHLBB between 1981 and 1982.

(Footnote Continued)
were used (between March 1978 and July 1980) had involved regulatory violations, not financial soundness issues. Regulatory violations and safety and soundness problems were found in twenty cases, and only ten cases involved only safety and soundness problems. Thus, enforcement actions were being used somewhat more to deal with regulatory violations than with safety and soundness problems.

[10] This is well documented in the GAO's 1981 report cited above.

[11] The 1981 Annual Report of the Federal Home Loan Bank Board (page 8) summarized this philosophy succinctly: "The savings and loan industry in the U.S. has been over-regulated. This regulatory zeal was intended to serve two purposes -- one, to assure a supply of relatively low-cost mortgage credit and, two, to preserve the safety of deposits. With hindsight, it appears this approach may have been fundamentally in error, despite the value of the goals being served."

- Although Congress, in CEBA, mandated that S&Ls move to a GAAP accounting basis by December 31, 1987, the FHLBB used provisions designed for specific and exceptional cases to postpone compliance for all FSLIC-insured institutions for one year. Individual institutions can still be exempted until the end of 1993.
- A provision also existed under CEBA which allowed institutions in general to retain net worth elements previously derived from the 1981-1982 concessions.

The FHLBB made several concessions in accounting standards during 1981 and 1982 to permit FSLIC-insured institutions to show higher amounts of net worth than would otherwise have been the case:

- In September 1981, troubled institutions were authorized to issue special securities (income capital certificates) to be purchased by the FSLIC, either with cash or interest-bearing FSLIC notes, and to be included as net worth by the issuing institutions. The passage of the Garn-St Germain Act in October 1982 authorized the FSLIC and FDIC to purchase net worth certificates issued by troubled institutions.
- Also in September 1981, FSLIC-insured institutions were permitted to defer and amortize over a period of years the losses sustained on sales or other dispositions of mortgage loans, mortgage-related securities and debt securities.
- In July 1982, the FHLBB permitted goodwill resulting from the acquisition or merger of an S&L institution to be amortized over a long period (40 years), while the income realized from the difference between the book and market values of assets could be accumulated over a short period (5 to 10 years). The amortization period for acquisition goodwill was later reduced to 25 years.
- In August 1982, the FHLBB authorized insured institutions to include in regulatory net worth any subordinated debentures, redeemable mutual capital certificates, and nonpermanent preferred stock having a remaining term-to-maturity or term-to-redemption exceeding one year.
- In November 1982, FSLIC-insured institutions were permitted to increase their net worth positions on the basis of the appraised values of premises and related real estate.

In 1986, net worth certificates, deferred losses, acquisition goodwill, subordinated debt, and appraised equity capital amounted to $13.4 billion -- equal to 25 percent of the $53 billion of regulatory net worth of S&Ls, and equal to 1.15 percent of their total assets of $1,172 billion.[12] This measures the conceptual difference between "RAP net worth" and "GAAP net worth." Recent estimates from the FHLBB show that as of the end of June 1988, 2,596 "GAAP solvent" institutions had RAP net worth equal to 5.8 percent of assets and GAAP net worth equal to 5.1 percent of total assets. For the 496 "GAAP insolvent" institutions, RAP net worth was -4.8 percent of total assets and GAAP net worth was -8.6 percent of total assets.

The consequence of permissive accounting is painfully clear when the length of insolvency is measured using different accounting principles (see Graph 1).

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[12] R. Dan Brumbaugh, Jr. Thrifts Under Siege, page 45.

On a regulatory accounting basis, only 17 FSLIC-insured institutions reported negative net worth for five years or more.[13] However, on a GAAP basis, over 100 FSLIC-insured institutions had negative net worth for over five years, and on a tangible capital basis -- which is closer than GAAP to the accounting principles used in determining the net worth of commercial banks -- more than 225 S&Ls had negative net worth for over five years.

The accounting concessions made by the FHLBB in 1981 and 1982 were initially aimed at "buying time" for FSLIC-insured institutions to recover from the damage done to their net worth positions by the 1979-1981 upswing in interest rates. However, efforts to buy time in the short run had serious longer-term consequences. This is illustrated clearly in the regulation permitting deferral of losses on loan sales. Strunk and Case make the following observation on this point:

> This regulation had the temporary effect of boosting income because associations could sell lower rate loans and reinvest in more profitable assets. But as it turned out, this provision encouraged associations to dump their low rate and lower valued assets at just the wrong time. Hindsight shows that they could have sold these loans at much higher prices. The amortization of the loss deferral is now a drag on earnings for those who took advantage of this authority.[14]

For many institutions "buying time" was not an appropriate strategy. Changes in the financial environment had made them uneconomic units, regardless of the amount of time they might be given to try to effect recovery. A number of these uneconomic units, seeing that there might be no tomorrow, were the ones that gambled in 1983-1985 on programs of aggressive expansion of high-cost deposits and high-risk loans and investments.

Congress attempted to correct the accounting deficiencies and mandated, in CEBA, that FSLIC-insured institutions use GAAP accounting, effective December 31, 1987. The FHLBB, however used a provision in the Act designed to exempt individual S&Ls from compliance in special circumstances up to year-end 1993 to delay implementation for all FSLIC-insured institutions for one year. This action was disturbing in that it demonstrated the lack of commitment on the part of the FHLBB to correct past mistakes.

The rule promulgated by the FHLBB retained some RAP elements until January 1, 1994. More specifically, RAP may continue to be used in preparing unaudited regulatory financial statements beginning on or after January 1, 1989, for the following:

- o Deferred loan losses: These may continue to be reported through December 31, 1993. Beginning January 1, 1994, such losses and gains are not allowed.
- o Mutual funds: Investments in liquid asset mutual funds may be reported at cost through December 31, 1993. Beginning January 1, 1994, mutual funds must be reported in accordance with GAAP (SFAS 12).

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[13] Barth, James R. and Bradley, Michael G., "Thrift Deregulation and Federal Deposit Insurance," Office of Policy and Economic Research, Federal Home Loan Bank Board, 1987. The length of insolvency is calculated for those GAAP-insolvent FSLIC-insured institutions as of June 1988.

[14] Strunk and Case, Ibid, pages 37-8.

- Consolidated reporting: Financial statements may continue to be reported on an unconsolidated basis through December 31, 1989. Beginning January 1, 1990, consolidated reporting is required.

Thus, the FHLBB regulations not only delayed the effective date by one year, they also allowed the three RAP exceptions and a phase-in period not authorized by CEBA.

In light of the history of weak and permissive regulatory oversight of S&Ls, a system must be devised to ensure that those individuals who are responsible to regulate and supervise these institutions are held accountable for their actions. As part of a system of accountabilities, the FHLBB should publish and annually update a detailed three-year plan for strengthening its regulation and supervision; the Federal Financial Institutions Examinations Council should establish quality-control standards and review mechanisms; Congress should annually hold oversight hearings on the appropriateness of the FHLBB's plans and how well the FHLBB has met its goals; and the U.S. General Accounting Office should continue to test for compliance with statutory requirements, and good management and accounting standards.

The Lack of a Closure Policy

A pervasive theme underlying the regulatory and supervisory decisions reviewed in this paper was to keep insolvent and nearly-insolvent FSLIC-insured institutions in operation in the hopes that someday they would regain their viability. While there may be unusual circumstances that would lead to forestalling the closure of a particular institution, the FHLBB took the position in all aspects of its regulation and supervision that problem S&Ls should be saved.

As is now painfully obvious, this policy was dangerously shortsighted and served only to increase the ultimate cost of resolving the hundreds of insolvent FSLIC-insured institutions. In fact, of all the regulatory and supervisory failures, the lack of an adequate closure policy may be the biggest contributing factor to the huge losses that currently face the FSLIC. Regardless of the mix of assets in an S&L's portfolio, closing an institution at the point where capital is exhausted would minimize losses to the insurer. This may well explain why the FSLIC's losses have been enormous compared to losses at the FDIC. The FHLBB should adopt the same policies and procedures as those of the bank regulators in closing institutions that become insolvent.

No complicated early warning system was needed to see the problems that were developing. High rates of growth and high interest rates paid on deposits were clear signs to S&L regulators that concern was warranted. But weak regulatory, supervisory, and accounting standards allowed insolvent S&Ls to continue to operate and continue to make risky, uneconomic investments.

Table 1

Example of the Impact of the Five-Year Deposit Averaging Scheme on Net Worth

Year	Deposits	5-year Deposit Average	Net Worth Requirement	Net Worth as a percent of year-end Deposits	Increase in Net Worth as a Percent of the Change in Deposits
		($ Millions)			
1977	$100				
1978	110				
1979	120				
1980	130				
1981	140	$120	$3.60	2.6	
1982	210	142	4.26	2.0	.92

Table 2

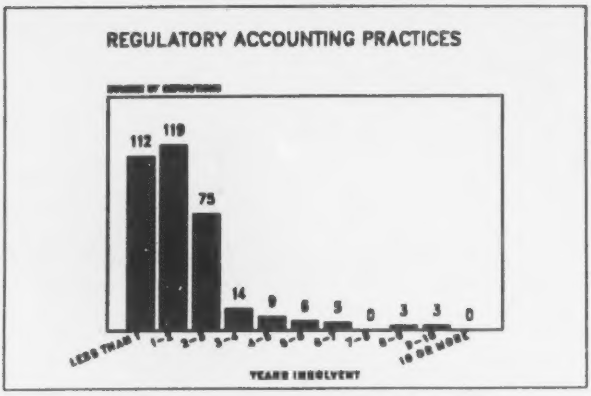
Use of Enforcement Powers by the FHLBB*

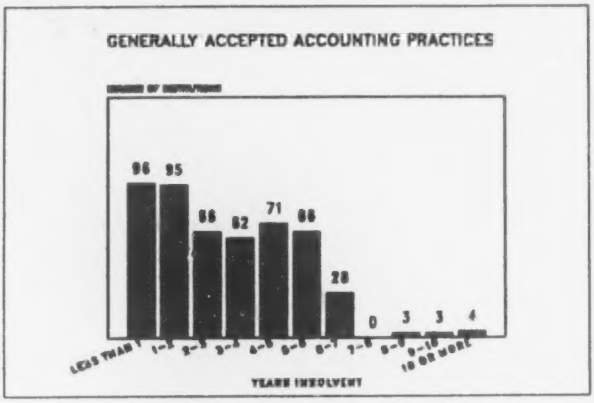
Year	Cease & Desist Orders	Removal of Officers	Supervisory Agreements	Formal Investigations
1975	13	-	10	41
1976	8	-	41	46
1977	13	-	14	21
1978	9	-	9	37
1979	7	4	7	20
1980	3	1	1	6
1981	8	2	0	8
1982	13	6	5	10
1983	17	21	39	17
1984	13	22	116	24
1985	28	22	233	30
1986	58	48	214	30

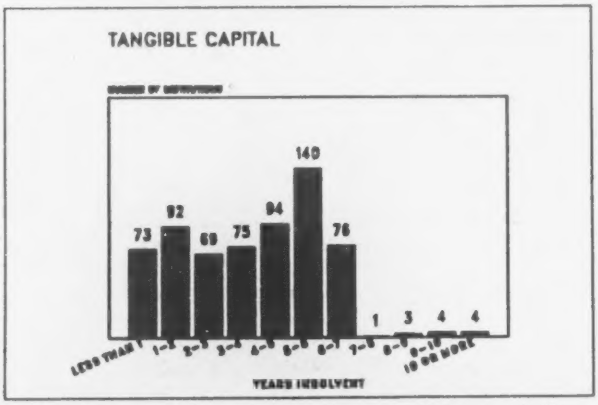
Source: Strunk and Case, Ibid., p. 125

*Comparing the extent of FHLBB's use of enforcement actions to the use of such actions by the federal bank regulatory agencies is complicated by differences in the numbers and sizes of institutions under the respective agencies.

GRAPH 1
LENGTH OF INSOLVENCY OF INSOLVENT S&Ls



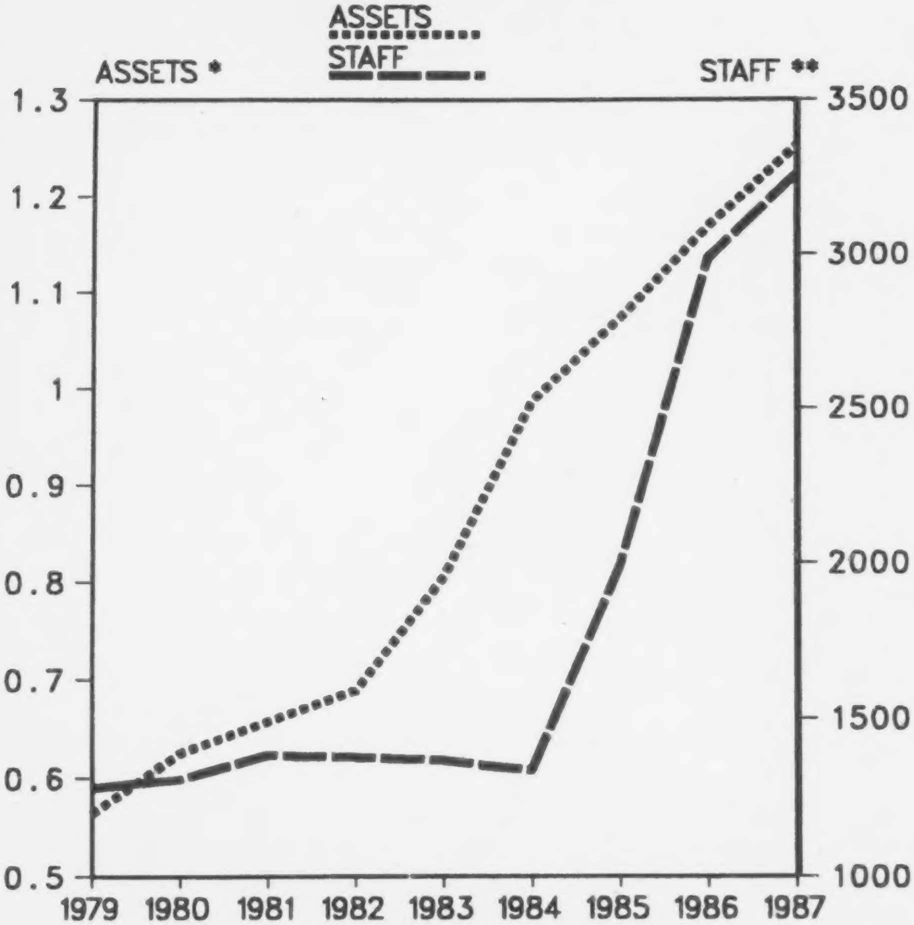




Source: James R. Barth and Michael G. Bradley. ThriftDeregulation and Federal Deposit Insurance. Office of Policy andEconomic Research, FHLBB.

GRAPH 2

THRIFT REGULATORY STAFF AND INDUSTRY ASSETS



* ASSETS IN BILLIONS OF DOLLARS.

** STAFFING FIGURES BASED ON FULL-TIME EQUIVALENT PERSONNEL ENGAGED IN EXAMINATION AND/OR SUPERVISION AT BOTH THE BANK BOARD AND DISTRICT BANKS.

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Henry Ruempler
Tax Counsel

QUESTIONS FOR THOMAS LABRECQUE
FROM SENATOR JOHN HEINZ
HEARINGS ON FINANCIAL MODERNIZATION
APRIL 3, 1990

(CONTINUED)

Q.2. Mr. Downey argues on Page 7 of his written testimony that only those activities that serve an important public policy function should be funded with insured deposits. Do you agree? Based on this criterion, where should the line be drawn? What factors should Congress consider in determining which activities merit funding with insured deposits?

A.2. Mr. Downey's suggestion must be answered with the question -- what is an "important public policy function"? Consumer lending? Mortgage lending? Commercial lending? Government securities underwriting to finance our government's operations? Corporate securities underwriting to finance job creation and economic competitiveness? Insurance brokerage and underwriting to protect households and businesses against insurable economic risks?

I am not suggesting that securities and insurance activities should be financed with insured deposits. I am only suggesting that the distinction Mr. Downey points to does not exist. More practically, an approach to financial modernization which does not become entangled with these tail-chasing questions is some form of diversified financial service company in which the various banking, securities, and insurance activities are conducted by separately capitalized subsidiaries. There are a variety of proposals along these lines for Congress to consider.

A central question in discussions of diversified financial company proposals is the matter of "firewalls". At its heart, this is the central concern of Mr. Downey's suggestion. Attached is the most thorough discussion of the "firewall" issue currently available. Because the attached paper is an integral part of my response to this question, I ask that it appear in its entirety as part of my response.

The American Bankers Association and the other trade groups I represented in my appearance before the Committee urge that timely consideration be given to all the financial modernization proposals now on the table and that careful attention be paid to the modernization processes now underway in Europe and Asia.

REWALLS

APRIL 1990

Mellon Bank • Banc One Corporation • J.P. Morgan & Co. Incorporated •
Northern Trust Company • South Carolina National Bank • Security Pacific Corporation •
American Bankers Association • PNC Financial Corp • First Bank System, Inc. •
Ameritrust • Citibank • First Chicago Corporation • NCNB National Bank •
Fleet/Norstar Financial Group, Inc. • Association of Bank Holding Companies •
Manufacturers Hanover Corporation • Bank Capital Markets Association •
Barnett Banks, Inc. • Barclays Bank • Norwest Corporation •
Coalition for Regional Banks • Chase Manhattan Bank • Bankers Trust Company •
Association of Reserve City Bankers • Bank of Boston •
Davis Polk & Wardwell • Cleary, Gottlieb, Steen & Hamilton •
Wilmer, Cutler & Pickering

"[O]ur laws greatly inhibit the ability of U.S. banks to evolve along with technological and other changes and to achieve the synergies that come from producing multiple, but similar, products and services. Particularly burdensome ... is the Glass Steagall Act .... [A]reas to consider involve those rules and regulations that can impinge on banks' costs .... I am not suggesting that they be abandoned simply because they impose costs on banks. What I am suggesting, however, is that we be cognizant of such costs when we weigh the benefits of our policies in terms of our other objectives."

Chairman Alan Greenspan, Federal Reserve Board, Testimony before the Subcommittee on Financial Institutions of the House Committee on Banking, Finance and Urban Affairs, April 4, 1990

* * *

"[The] fragmented structure [of the U.S. financial system] creates countless obstacles that prevent the financial industry from functioning efficiently, profitably and with diversity of risk .... Price, product, investment and territorial limits undercut competition and should be eliminated. This means repeal of Glass-Steagall, McFadden and the Bank Holding Company Act .... [W]e must take care that any alternative corporate form not be competitively disadvantaged.... [F]irewalls [between banking and securities affiliates] should be designed *only* to protect against *real* abuse and not to prohibit interactions within an institution."

Thomas W. Strauss, President, Salomon Brothers Inc., Remarks before the Institute of International Bankers, February 12, 1990 (Emphasis in original)

* * *

"There is little evidence of any bank safety-and-soundness concerns, conflicts-of-interest abuse or undue concentrations of resources from the interaction of banking and nonbanking activities either [in the United States], or abroad where much greater interaction has traditionally been permitted ... The major conclusion of *Mandate for Change* [the FDIC's 1987 study on the need for restructuring the U.S. banking industry] is that insulation [of banking entities from nonbanking affiliates] through the creation of a supervisory wall can be achieved. The tools needed for insulating banks and establishing the 'supervisory wall' are only a logical extension of safeguards that exist today to protect banks from inside abuse and conflicts of interest."

Chairman L. William Seidman, Federal Deposit Insurance Corporation, Testimony before the International Competitiveness Task Force of the House Committee on Banking, Finance and Urban Affairs, March 22, 1990.

* * *

"If our banks and our overall economy are to remain competitive in international markets, it is essential that we remove costly restrictions that are not needed to ensure the safety and soundness of the U.S. banking system .... [W]e should seriously reconsider the need for existing restrictions on securities activities and other expanded powers of commercial banks."

Comptroller of the Currency Robert L. Clarke, Letter to Congressman John J. LaFalce, Chairman, Task Force on the International Competitiveness of U.S. Financial Institutions, March 1, 1990.

* * *

TABLE OF CONTENTS

PAGE

FOREWORD 2

ARE NEW RESTRICTIONS NECESSARY? 3

A. Securities Activities Are No Riskier Than Other Banking Activities 4

B. A Comprehensive Regulatory Regime Already Governs the Activities of Banks and Securities Affiliates 4

C. There Is No Evidence That New Restrictions Are Necessary... 7

ANALYSIS OF SPECIFIC FIREWALLS 10

A. Corporate Separateness Firewalls 10

1. Separately Incorporated and Capitalized Affiliates 10

2. Personnel Interlocks Between Banks and Securities Affiliates 12

3. Cross-Marketing Restrictions 13

4. Common Names, Premises and Advertising.............. 14

B. Bank Credit Facility Firewalls 15

1. Extensions of Credit to Securities Affiliates 15

2. Extensions of Credit to Issuers of Securities 16

3. Extensions of Credit to Purchasers of Securities 18

C. Bank Transaction Firewalls 19

1. Purchases of Securities Underwritten by Securities Affiliates 19

2. Trust Account Purchases from Securities Affiliates 21

3. Purchases of Financial Assets from Securities Affiliates.... 22

PAGE

4. "Tying" 23
5. Discrimination Against Unaffiliated Securities Firms 24
6. Underwriting Asset-Backed Securities Issued by Affiliated Banks 25

APPENDICES

A. Sections 23A and 23B of the Federal Reserve Act—Text .... *
B. Summary of Practical Impact of Sections 23A and 23B .... *
    1. Chart: Illustration of Sample Procedure to Comply with Sections 23A and 23B in Responding to a Request by a Nonbank Affiliate for an Extension of Credit, with Collateral Provided by the Bank Holding Company .... *
C. Firewall Provisions in Section 20 Orders .... *
D. "Existing Safeguards for Regulating Transactions Between Banks and Their Affiliates," Appendix to the Comptroller of the Currency's Response to Inquiry by Subcommittee on Telecommunications and Finance of House Energy and Commerce Committee (Dec. 4, 1987) .... *
E. Enforcement Powers and Penalties in Federal Regulation of Depository Institutions .... *

FOREWORD

Much discussion and deliberation has taken place over the past few years concerning changes in the financial services market. Congress has considered revisions to the current legal framework and the regulatory agencies have acted to permit or restrict new activities under existing law. Most observers now agree on the need to revise one of the major constructs of the system, the Glass-Steagall Act.

The financial services market has continued to evolve. The most dramatic change has been the increased offering of products and services by various companies beyond traditional lines. Insurers provide banking products, banks provide securities products and securities firms provide banking products. While there never has been an impenetrable barrier between different financial services sectors, regulatory limits on the provision of products and services have resulted in inefficiencies that have injured consumers and now threaten the health of the domestic industry in the face of aggressive foreign competition.

Each time change is proposed at the legislative and regulatory level it is accompanied by proposals to add new restrictions. There appears to be a consistent failure to review *existing* safeguards to determine their sufficiency or efficacy.

"Firewalls"

While a more appropriate description of restrictions proposed in connection with financial services reform might be "limitations on relationships and transactions between insured depositories and their affiliates," the term that is commonly used is "firewalls" and that term will be employed here. While firewalls may be imposed in connection with the provision of a wide range of products and services, they have been proposed most often in connection with affiliations between securities firms and banking organizations. This will be the context in which they are reviewed in this paper.

This paper does two things. First, it critically examines in light of existing law and market realities the firewalls that have been proposed. Second, the paper demonstrates that existing law more than adequately addresses any concerns about affiliations between banks and securities firms.

Financial services firms value effective and prudent regulation. Such regulation enhances market efficiency and consumer confidence. This paper demonstrates that existing law, without any material changes or additions, provides such regulation.

ARE NEW RESTRICTIONS NECESSARY?

A consensus has developed that our nation's financial services laws must change to increase the competitiveness of our banks and other financial intermediaries, particularly in light of the challenge from larger and more diversified foreign banking institutions. Reform of our out-dated laws would allow our financial intermediaries, like their competitors from abroad, to provide a full range of financial services, including "banking" and "securities" services, to their customers.

The question now is not *whether* to reform our out-dated financial services laws, but *how*. A large part of the debate about the mechanics of modernization focuses on firewalls—restrictions on relationships between insured depository institutions and affiliates that provide securities or insurance or other financial services and products that banks are prohibited from providing, in whole or in part. Many of the firewalls that have been proposed, however, are unnecessary and will prevent U.S. banking organizations from competing effectively with domestic and foreign institutions that are not similarly constrained.

Firewalls became part of the language of reform in connection with various orders issued by the Federal Reserve Board over the past several years that have permitted banking organizations to engage in certain securities activities. The firewalls are descendants of restrictions that were initially imposed in connection with commercial paper placement activities conducted by *banks*. These restrictions were expanded in connection with limited securities underwriting and dealing activities conducted by nonbank subsidiaries of bank holding companies.[1] The Federal Reserve Board developed the firewalls in an effort to address the concerns that led Congress to adopt the Glass-Steagall Act — the very statute most observers now agree must be changed.[2]

Restraints developed to implement out-dated laws should not be incorporated into new laws purportedly designed to permit U.S. financial institutions to compete effectively in the modern marketplace. At the very least, the wisdom of imposing those restraints should be critically re-examined.

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[1] *See J.P. Morgan*, 75 Fed. Res. Bull. 192 (1989) ("1989 Order"); *Citicorp*, 73 Fed. Res. Bull. 473 (1987) ("1987 Order"); *BT Commercial*, 73 Fed. Res. Bull. 138 (1987); Federal Reserve Board, Statement Concerning Applicability of the Glass-Steagall Act to the Commercial Paper Placement Activities of Bankers Trust Company (June 4, 1985) ("Commercial Paper Statement").

[2] Moreover, in both the 1987 and 1989 Orders, the Federal Reserve Board noted that after the securities subsidiaries had established a "record of experience in the proposed activities," the Board would "review the continued appropriateness of particular limitations." 75 Fed. Res. Bull. at 210; *see also* 73 Fed. Res. Bull. at 504. As a practical matter, the ability to review particular "firewalls" based on experience would be severely limited if the "firewalls" were imposed by statute.

A. Securities Activities Are No Riskier Than Other Banking Activities

While securities activities do pose some risks, it is well-recognized that they are *no* riskier than other activities in which banks and their affiliates currently engage.[3] As the Senate Committee on Banking, Housing and Urban Affairs noted in 1988:

> "A careful examination of the practice of securities underwriting reveals that it is a less risky activity than is commonly believed. Recent innovations in risk management techniques diminish underwriting risk even further and strengthen the case for repeal of the restrictions on bank entry into the market for underwriting services."[4]

Similarly, the House Committee on Government Operations has concluded that "there is no empirical confirmation of the concerns of those who suggest that expanded authority for banking firms to engage in broader securities activities would entail excessive risks for the banks involved."[5]

Since expanded securities activities would pose no special risks, there is no justification for imposing special restrictions and limitations on affiliations between banks and securities firms.

B. A Comprehensive Regulatory Regime Already Governs the Activities of Banks and Securities Affiliates

Proponents of "firewalls" fail to recognize the development over the past 50 years of a highly sophisticated regulatory regime governing the activities of banks, bank holding companies and securities firms. This regime consists of provisions such as Sections 23A and 23B of the Federal Reserve Act, Section 106(b) of the Bank Holding Company Act Amendments of 1970, the federal securities laws, and state banking and securities laws. The safeguards established by existing law more than adequately insulate banks from the activities of their affiliates and effectively address any concerns about affiliations between banks and securities firms. As the Federal Deposit Insurance Corporation (the "FDIC") has noted, "transactions between banks and nonbank affiliates currently are subject to very tight restrictions, and . . . few changes to existing law would be necessary to protect the system even if a very conservative approach were taken."[6]

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[3] The Congress that adopted the Glass-Steagall Act misperceived the role banks' securities activities played in the development of the banking crisis in 1933. As the President's Council of Economic Advisers has observed, "there is no evidence to support [the] proposition [that] bank failures in the early 1930's were [attributable] to the role of banks in the securities business." Economic Report of the President at 148 (1984). *See also* Statement of Alan Greenspan, Chairman, Board of Governors of the Federal Reserve System, Before the Senate Comm. on Banking, Housing and Urban Affairs at 13 (Dec. 1, 1987) ("research over the past 50 years concludes, contrary to Congress' view at the time, that bank securities activities were not a cause of the Great Depression and that banks with securities affiliates did not fail in proportionately greater numbers than banks more generally"); Federal Deposit Insurance Corporation, *Mandate for Change* at ix, 44 (1987).

[4] S. Rep. No. 305, 100th Cong., 2d Sess. at 11 (1988) ("PROXMIRE REPORT").

[5] H. Rep. No. 100-324, 100th Cong., 1st Sess. at 37 (1987) ("GOVERNMENT OPERATIONS COMMITTEE REPORT"); Litan, What Should Banks Do? at 89 (1987) ("researchers have recently reported findings demonstrating that the risks of corporate securities underwriting are, if anything, lower than for other types of securities that banks are permitted to underwrite under exceptions to the Glass-Steagall Act").

Section 23A of the Federal Reserve Act limits the aggregate amount of "covered transactions" between a bank and an affiliate to 10% of the capital stock and surplus of the bank. "Covered transactions" include loans or extensions of credit to an affiliate; purchases of, or investments in, securities issued by an affiliate; purchases of assets, including assets subject to an agreement to repurchase; the acceptance of securities issued by an affiliate as collateral security for a loan or extension of credit to any person or company; and the issuance of a guarantee, acceptance, or letter of credit, including an endorsement or standby letter of credit, on behalf of an affiliate. Moreover, Section 23A imposes stringent collateral requirements (100% to 130%) on each loan or extension of credit to, or guarantee, acceptance, or letter of credit issued on behalf of, an affiliate. Finally, Section 23A generally prohibits a bank from purchasing low-quality assets from an affiliate.[7] (See Appendices A and B)

In 1987 Congress adopted Section 23B of the Federal Reserve Act.[8] Among other things, Section 23B requires transactions between a bank and its affiliates to be on terms at least as favorable to the bank as those prevailing for comparable transactions with unaffiliated companies. Section 23B also imposes restrictions on bank fiduciary transactions involving assets or securities obtained from affiliates and limits a bank's ability, as principal or fiduciary, to purchase securities underwritten by an affiliate. Taken together, Sections 23A and 23B insulate banks from their affiliates and effectively restrict harmful loan and securities transactions between banks and their affiliates.

In addition, Section 106(b) of the Bank Holding Company Act Amendments of 1970 eliminates any possibility that banks and their securities affiliates might enter into "tying" arrangements. Section 106(b) makes it *per se* illegal for banks to extend credit (or adjust the price of such credit) on the condition or requirement that a customer purchase some other product or service from affiliates, including securities affiliates.[9]

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[6] Federal Deposit Insurance Corporation, *Mandate for Change* at 95 (1987); *see also* Appendix D ("Existing Safeguards for Regulating Transactions Between Banks and Their Affiliates").

[7] 12 U.S.C. § 371c.

[8] *Id.* at § 371c-1.

[9] 12 U.S.C. § 1972. *See Parsons Steel, Inc.* v. *First Alabama Bank of Montgomery*, 679 F.2d 242, 245 (11th Cir. 1982) ("[T]he purpose and effect of [Section 106(b)] is to apply the general principles of the Sherman Antitrust Act prohibiting anticompetitive tying arrangements specifically to the field of commercial banking, without requiring plaintiffs to establish the economic power of a bank and specific anticompetitive effects of tying arrangements"). *See also* 12 C.F.R. § 225.4(d) ("A bank holding company and any nonbanking subsidiary . . . may not in any manner extend credit, lease or sell property of any kind, provide any service, or fix or vary the consideration for any of these transactions subject to any condition or requirement that, if imposed by a bank, would constitute an unlawful tie-in arrangement under [Section 106(b)]").

Any concern over voluntary tying arrangements or "tying effect" is unjustified in view of the competitive nature of the credit markets. The Federal Reserve Board "believes that the potential for 'voluntary tying' is structural, based upon the nature of competition in the relevant market areas, and that voluntary tying is not a problem in competitive markets." *Citicorp* [1981-82 Transfer Binder] FED. BANKING L. REP. (CCH) par. 98,708 at 85,303 (1981). *See also* Economic Report of the President at 162 (1984).

The federal securities laws address other proposed restrictions on relationships and transactions between banks and their securities affiliates. Section 7 of the Securities Exchange Act of 1934 (the "1934 Act"), for example, authorizes the Federal Reserve Board to regulate extensions of credit to finance the purchase of equity securities and, accordingly, reduces the already remote possibility that banks might make unsound loans to purchasers of securities distributed by their affiliates or have difficulty in insisting upon the maintenance of adequate margins on such loans.[10] Similarly, Section 11(d)(1) of the 1934 Act prohibits a securities firm from directly or indirectly arranging for "the extension or maintenance of credit to or for a customer on any security . . . which was part of a new issue in the distribution of which [the firm] participated as a member of a selling syndicate or a group within 30 days prior to such transactions . . . ."[11]

Moreover, the securities affiliates contemplated by the various Glass-Steagall Act reform proposals would be separately capitalized nonbank subsidiaries of banks or bank holding companies and, as such, *would be required* to register as broker-dealers under the 1934 Act and would be subject to all applicable federal *and* state securities laws. The 1934 Act establishes a comprehensive structure for the regulation of securities broker-dealers and prohibits manipulative or deceptive practices. The detailed disclosure requirements and antifraud provisions of the 1934 Act and the Securities Act of 1933 (the "1933 Act") effectively eliminate the possibility that investors will not be informed about the securities they purchase. And the Investment Advisers Act of 1940 is designed "to eliminate, or at least expose, all conflicts of interest which might tempt an investment adviser — consciously or unconsciously — to render advice which [is] not disinterested."[12]

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[10] 15 U.S.C. § 78g. It would make little sense for a bank to expose itself to the losses associated with unsound loans so that its affiliate could earn a fraction of those potential losses on the sale of securities.

[11] *Id.* at § 78k(d)(1).

[12] *SEC* v. *Capital Gains Research Bureau*, 375 U.S. 180, 191-92 (1963). The Investment Advisers Act is codified at 15 U.S.C. § 80b-1 *et seq.*

The extent to which a comprehensive regulatory regime has developed over the past 50 years is graphically demonstrated by the following list of statutes and regulatory agencies that are implicated by affiliations between banks and securities firms.

Statutes

Federal Reserve Act
Federal Deposit Insurance Act
National Bank Act
Bank Holding Company Act of 1956
Bank Holding Company Act Amendments of 1970
Securities Act of 1933
Securities Exchange Act of 1934
Trust Indenture Act of 1939
Investment Company Act of 1940
Investment Advisers Act of 1940
Government Securities Act of 1986
Commodity Exchange Act
Clayton Act
Sherman Act
State banking and securities laws

Regulatory Bodies

Federal Reserve Board
Federal Deposit Insurance Corporation
Comptroller of the Currency
Securities and Exchange Commission
National Association of Securities Dealers
New York Stock Exchange
Other national and regional securities exchanges
Municipal Securities Rulemaking Board
Commodity Futures Trading Commission
Department of the Treasury
Department of Justice
State regulatory agencies

C. There Is No Evidence That New Restrictions Are Necessary

There is no evidence to indicate that new statutory restrictions are necessary. The Glass-Steagall Act itself permitted banks and their affiliates to engage in a wide range of securities activities. In particular, banks and their affiliates were permitted to engage in underwriting and dealing in U.S. government securities and other governmental obligations, securities brokerage, and private placements of corporate debt and equity securities. In 1985 the Board noted that the three federal banking agencies "exhaustively reviewed the activities of banks in privately placing long term debt and equity securities and found no empirical evidence that these activities resulted in harm to the bank or conflicts of interest."[13] More recently, the Federal Reserve Board has stated:

> "[A]lthough to some extent, the potential for conflicts of interest exists in connection with permissible securities and lending activities presently engaged in by member banks, there is *no* evidence that bank underwriting of eligible securities over the past 50 years has produced serious conflicts of interest or other abuses or encouraged imprudent lending practices."[14]

Similarly, banks and their affiliates have been major participants in the asset-backed securities markets with no evidence of abuse. Several foreign banking organizations have been involved in underwriting and dealing in securities in the United States for many years through entities grandfathered under the International Banking Act. Finally, no evidence exists of any abuse in connection with the limited corporate securities underwriting activities conducted by the "Section 20" affiliates of U.S. banking organizations or in connection with the extensive securities underwriting and dealing activities conducted abroad by affiliates of U.S. banks.

In the absence of evidence that firewall provisions are necessary to address real, as opposed to imagined, problems, they should not be adopted. In addition to being unjustified, the adoption of such provisions would affect adversely the international competitiveness of U.S. banking and other financial organizations and reduce the benefits that affiliations between banks and securities firms would otherwise produce.

There are those who argue that firewalls are necessary to protect the federal deposit insurance fund. As discussed above, however, securities activities are not materially different from, or riskier than, "banking" activities. In fact, a "securities" activity such as holding marketable securities as an underwriter or dealer for a short period of time is considerably less risky than making a long-term, illiquid loan.

The experience of U.S. banking institutions confirms this point. Here at home U.S. banking institutions have successfully participated in the volatile government securities markets and the sometimes thin municipal bond markets. Abroad, U.S. banking institutions have successfully participated in the markets for equity and debt securities. There have been no failures and no threats to the deposit insurance fund. Moreover, the international experience teaches us that systems of supervision and regulation that do not involve firewalls are working. The banking systems in Germany, the Netherlands, and Switzerland, for example, are free of rigid prohibitions with respect to (i) funding and capital support, (ii) marketing, (iii) relationships with customers, and (iv) use of personnel.

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[13] Commercial Paper Statement at 38.

[14] 1987 Order at 496 (emphasis in original). *See also* U.S. Department of Treasury, Public Policy Aspects of Bank Securities Activities at 35 (1975) ("there is *no record of actual conflicts* arising from commercial bank underwriting of general obligation municipals during the past 40 years that they have engaged in such activity") (emphasis added).

A real threat to the deposit insurance fund could arise from unnecessarily stringent firewalls. Such firewalls would result in the loss of competitive opportunities to securities firms and foreign banks and create disincentives to diversification, which has long been recognized as essential to the safety and soundness of banks and the health of corporations generally. President E. Gerald Corrigan of the New York Federal Reserve Bank has stated:[15]

> "As I have strongly maintained for many years, firewalls serve a very useful purpose but taken to the extreme they can: (1) essentially cancel out the competitive and economic advantages associated with combining different classes of financial activities under common ownership; (2) create unnecessary and potentially dangerous tensions in our relations with foreign institutions and their supervisors; (3) impede the international competitiveness of U.S. firms; and (4) give rise to a false sense of security concerning the stability of the banking and financial systems as a whole."[15]

There is similarly no substance to the claim that banking organizations have an unfair competitive advantage because bank deposits are insured. As to securities activities conducted in the bank itself, the substantial costs of being in the business of banking—including insurance assessments, reserve requirements and comprehensive regulatory oversight—reduce any possible funding advantage. As to those activities conducted in affiliates, Sections 23A and 23B prevent banks from passing on any alleged advantage to their affiliates. In particular, Section 23B prohibits extensions of credit (or other transactions with an affiliate) except on terms that are at least as favorable to the bank as those prevailing for comparable transactions with unaffiliated companies. Banks (including banks affiliated with securities firms) make substantial loans to unaffiliated securities firms every day. Under Section 23A, loans to affiliated securities firms must be made on the same terms as they are made to nonaffiliated companies, so there is no competitive advantage conferred on affiliated firms. In fact, the collateralization requirements imposed by Section 23A would put affiliated firms at a competitive *disadvantage* in relation to unaffiliated firms.

In short, expanded securities activities pose no threat to the deposit insurance fund and would result in no competitive advantage for banking organizations. And the comprehensive regulatory regime established by existing federal and state banking, securities, fiduciary and antitrust laws is more than adequate to address any other concerns that might arise.

* * *

The succeeding sections of this paper analyze the specific firewall proposals that have been made in connection with Glass-Steagall Act reform. As the following sections and Appendices B and D indicate, existing laws provide ample authority for effective regulation; ensure supervisory oversight through extensive reporting, recordkeeping and examination requirements; and, impose stiff civil and criminal penalties for violations.

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[15] Address before the Institute of International Bankers, New York, New York (May 23, 1989).

ANALYSIS OF SPECIFIC FIREWALLS

A. Corporate Separateness Firewalls

1. *Separately Incorporated and Capitalized Affiliates*

Proposals. The Glass-Steagall Act reform legislation passed by the Senate and approved by the House Banking and Energy and Commerce Committees in 1988 would have required underwriting and dealing in securities which banks themselves may not underwrite or deal in ("bank-ineligible securities") to be conducted in separately incorporated and capitalized holding company subsidiaries. *See* S. Rep. No. 305, 100th Cong., 2d Sess. (1988); H.R. Rep. No. 822, 100th Cong. 2d Sess. (1988) (Part 1); H.R. Rep. No. 822, 100th Cong., 2d Sess. (1988) (Part 2).[16]

Existing Law. Banks themselves are permitted to underwrite and deal only in U.S. government and certain other governmental or quasi-governmental obligations ("bank-eligible securities").

Bank holding companies, with the prior approval of the Federal Reserve Board under the Bank Holding Company Act, 12 U.S.C. § 1841 *et seq.*, can establish nonbank subsidiaries to engage to a limited extent in underwriting and dealing in bank-ineligible securities. The extent to which these subsidiaries can engage in such activities is defined by the "engaged principally" standard in Section 20 of the Glass-Steagall Act. *Id.* at § 377. The Federal Reserve Board currently permits these subsidiaries to derive up to 10% of their gross revenues from bank-ineligible securities underwriting and dealing activities. 75 Fed. Res. Bull. 751 (1989).

State-chartered banks that are neither members of the Federal Reserve System nor subsidiaries of bank holding companies may establish *direct* subsidiaries to underwrite and deal in bank-ineligible securities. 12 C.F.R. § 337.4. The FDIC believes that securities firms may be safely established as direct subsidiaries of banks. FDIC, *Mandate for Change* at 75 (1987).

Analysis. Although a requirement to conduct bank-ineligible securities activities in separately incorporated and capitalized nonbank subsidiaries is unnecessary to protect banks from risk, such a requirement facilitates "functional regulation" by providing the Securities and

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[16] The different versions of this legislation are referred to in this paper as the Senate bill, the House Banking Committee bill and the House Energy and Commerce Committee bill, respectively.

Exchange Commission (the "SEC") with clear regulatory jurisdiction and by subjecting these subsidiaries to the full range of federal and state laws applicable to securities broker-dealers, including "net capital" requirements. A bank holding company, however, should be able to establish a securities subsidiary as a direct subsidiary or as a subsidiary of one of its bank subsidiaries. As the FDIC has pointed out, separate incorporation and capitalization requirements shield a bank from liability for any losses the subsidiary might suffer, but the earnings of the subsidiary would generally be available to the bank in difficult times if the subsidiary were a subsidiary of the bank as opposed to the holding company. *See* FDIC, *Mandate for Change* at 92 (1987).

Although Sections 23A and 23B of the Federal Reserve Act do not apply to transactions between a bank and its direct nonbank subsidiaries, the FDIC has effectively extended Section 23A restrictions to direct securities subsidiaries of state nonmember banks. 12 C.F.R. §337.4(e)(6), (7). The Federal Reserve Board could also exercise existing authority under Section 23A to provide that transactions between banks and their securities subsidiaries are covered by Sections 23A and 23B.

2. *Personnel Interlocks Between Banks and Securities Affiliates*

Proposals. The Senate bill would have prohibited officer or director (but not employee) interlocks between securities affiliates and banks. The bill would have exempted certain small bank holding companies from this prohibition and would have granted general exemptive authority to the Federal Reserve Board. (§ 102, proposed BHCA § 4(c)(15)(F)(vi))

The House Banking Committee bill included essentially the same provision as the Senate bill. (§ 201, proposed BHCA § 9(h))

The House Energy and Commerce Committee bill would have extended the prohibition to employees (with a limited exception for certain back office operations) and would have granted the Federal Reserve Board exemptive authority, subject to SEC approval. (§ 201, proposed BHCA § 9(g))

The Federal Reserve Board's Section 20 orders prohibit personnel interlocks between banks and their securities affiliates. ·1989 Order, Condition No. 13. In its order applying the "firewall" provisions to the U.S. securities activities of *foreign* banking organizations, the Federal Reserve Board noted that it "will consider, based on experience with the operation of section 20 subsidiaries, whether modification of [the personnel interlock prohibition] would be appropriate consistent with the purposes of the section 20 prudential framework." *Canadian Imperial Bank of Commerce, Royal Bank of Canada, Barclays*, 76 Fed. Res. Bull. 158, 166 (1990) ("Foreign Bank Order").

Existing Law. Section 32 of the Glass-Steagall Act prohibits personnel interlocks between *member* banks and firms "primarily engaged" in bank-ineligible securities activities.

Analysis. So long as the separate corporate identities of banks and securities affiliates are maintained, there is no need to prohibit personnel interlocks between banks and securities affiliates. A flat prohibition on management interlocks increases, rather than reduces, risk because it limits the ability of senior management to oversee effectively the activities of various affiliates and restricts the availability of the most competent management in an organization. This is true for banking organizations of all sizes, but the problem would be especially severe for smaller banking organizations that do not have the personnel to cope with separate staffing requirements.

No evidence suggests that a prohibition on personnel interlocks is necessary to ensure that banks (or their customers) are not affected adversely by the activities of affiliates. For example, there have been personnel interlocks between banks and their foreign securities affiliates for years and there has been no evidence of problems.

3. *Cross-Marketing Restrictions*

Proposals. The Federal Reserve Board's Section 20 orders prohibit banks from acting as agent for, or engaging in marketing activities on behalf of, securities affiliates. Prospectuses or sales literature relating to securities being underwritten or dealt in by securities affiliates may not be distributed by banks or made available to the public at the banks' offices unless specifically requested by a customer. 1989 Order, Condition No. 16. In its order applying the "firewall" provisions to the U.S. securities activities of *foreign* banking organizations, the Federal Reserve Board noted that it "will consider, based on experience with the operations of section 20 subsidiaries, whether modification of the [cross-marketing] restrictions would be appropriate and consistent with the purposes of the section 20 prudential framework." Foreign Bank Order at 166.

The Senate bill, the House Banking Committee bill and the House Energy and Commerce Committee bill did *not* contain restrictions similar to those in the Section 20 orders. Instead, these proposals required certain disclosures regarding the uninsured status of securities affiliates and prohibited banks from expressing an opinion about securities offered by affiliates without disclosing the affiliates' role and interest with respect to the securities. (*See, e.g.*, Senate bill at § 102, proposed BHCA § 4(c)(15)(F)(vii), (viii) and (xi))

Existing Law. Section 23B of the Federal Reserve Act prohibits banks from publishing any advertisement or entering into any agreement stating or suggesting that the banks are in any way responsible for the obligations of their affiliates. 12 U.S.C. §§ 371c-1, 1828(j).

Federal and state securities laws prohibit material misstatements or omissions in connection with the offer or sale of securities and, therefore, would prohibit banks from suggesting that products offered by their affiliates were federally-insured or guaranteed by the banks.

Federal banking and antitrust laws prohibit "tying" arrangements and other anti-competitive practices and impose substantial civil (*i.e.*, treble damages) and criminal penalties for violations. 12 U.S.C. §§ 1972, 1975, 1976; 15 U.S.C. §§ 1, 14, 45.

Analysis. Reasonable disclosure requirements are far preferable to cross-marketing prohibitions. Such prohibitions needlessly deprive customers of convenient access to information about investment and distribution alternatives in an increasingly sophisticated financial world. The requirements of existing law, along with reasonable disclosure requirements regarding the status of securities affiliates and the products and services they offer, would be more than adequate to avoid customer confusion and to control any potential problems. As the House Committee on Government Operations has noted: "From the perspectives of bank safety and competitive fairness, [there is] no objection to permitting banks and their affiliates to cross-market each other's products. In fact cross-marketing, through the informational efficiencies and savings in customers' time that can result, may provide genuine consumer benefits." GOVERNMENT OPERATIONS COMMITTEE REPORT at 22.

4. *Common Names, Premises and Advertising*

Proposals. The Senate bill would *not* have prevented banks and securities affiliates from sharing names, premises and advertising.

The House Banking Committee bill would have prohibited banks and securities affiliates from sharing names, premises and advertising. (§ 201, proposed BHCA § 9(f))

The House Energy and Commerce Committee bill included a provision similar to the one in the House Banking Committee bill. (§ 201, proposed BHCA § 9(e))

The Federal Reserve Board's Section 20 Orders require banks and securities affiliates to have separate offices. 1989 Order, Condition No. 13. (A securities affiliate may have offices in the same building as a bank if the affiliate's offices are clearly distinguished from those of the bank.)

Existing Law. Section 23B of the Federal Reserve Act prohibits banks from publishing any advertisements or entering into any agreements stating or suggesting that the banks are in any way responsible for obligations of their affiliates. 12 U.S.C. §§ 371c-1, 1828(j).

Federal and state securities laws prohibit material misstatements or omissions in connection with the offer or sale of securities and, therefore, would prohibit banks or their affiliates from suggesting that products offered by the affiliates were federally-insured or guaranteed by the banks.

Analysis. Reasonable disclosure requirements are far preferable to prohibitions on shared names, premises or advertising. Disclosure is more than sufficient to ensure that the public will understand that a bank and its securities affiliate are different entities. Banks and bank holding companies have shared names with securities brokerage affiliates for years, and with Section 20 affiliates since 1987, and there is no evidence of any confusion on the part of their customers. Similarly, there have been no reports of public confusion about the identity and status of Merrill Lynch or American Express, even in light of the existence of Merrill Lynch Bank & Trust and American Express Centurion Bank, both of which are federally-insured banks.

As Federal Reserve Board Chairman Alan Greenspan advised the House Banking Committee in a July 21, 1988 letter: "[R]estrictions on cross marketing, such as joint advertising and the use of common name, logo and premises, that are principally restrictions on competition should be eliminated."

B. Bank Credit Facility Firewalls

1. *Extensions of Credit to Securities Affiliates*

Proposals. The Senate bill prohibited banks from extending credit to securities affiliates, with an exception for intra-day credit extended in connection with the clearing of U.S. Government and/or agency securities. (§ 102, proposed BHCA § 4(c)(15)(F)(i) and (ii))

The House Banking Committee and House Energy and Commerce Committee bills contained provisions similar to the one in the Senate bill. (§ 201, proposed BHCA § 9(a) and (k); § 201, proposed BHCA § 9(a) and (j))

The Federal Reserve Board's Section 20 Orders contain a similar restriction. 1989 Order, Condition No. 21(a) and (b). In its order applying the "firewall" provisions to the U.S. securities activities of *foreign* banking organizations, the Federal Reserve Board expanded the "clearing" exception to include Canadian government and/or agency securities. Foreign Bank Order, Condition No. 21(b). The expanded exception applies to both U.S. and foreign banking organizations.

Existing Law. Section 23A of the Federal Reserve Act limits a bank's extensions of credit to any one affiliate to 10% of the bank's capital and surplus. 12 U.S.C. §§ 371c, 1828(j).

Section 23A requires that loans and other extensions of credit to affiliates be collateralized at levels of up to 130% of the amount of the credit, depending on the type of collateral.

Section 23B of the Federal Reserve Act requires transactions between banks and affiliates to be conducted on arm's-length terms. 12 U.S.C. §§ 371c-1, 1828(j)

Analysis. Sections 23A and 23B adequately insulate banks from the activities of their affiliates, and there is no reason to impose special, more onerous restrictions on transactions between banks and *securities* affiliates. Securities activities are no riskier than other banking activities and, in fact, are *less* risky than lending. As the Senate Committee on Banking, Housing and Urban Affairs noted in 1988: "A careful examination of the practice of securities underwriting reveals that it is a less risky activity than is commonly believed." PROXMIRE REPORT at 11. Moreover, the collateral requirements imposed by Section 23A virtually eliminate risk as a factor.

The only way in which an unfair funding advantage could even arguably be conferred on securities affiliates would be through extensions of credit to affiliates at "bargain" rates. Section 23B, however, prohibits such extensions of credit — as well as other transactions with an affiliate — except on terms that are at least as favorable to the bank as those prevailing for comparable transactions with unaffiliated companies. Every day banks make substantial loans to unaffiliated securities firms and so long as loans to securities affiliates are made on the same, easily verifiable terms, no competitive advantage will be conferred on the affiliate. In fact, the collateralization requirements imposed by Section 23A put affiliated firms at a competitive *disadvantage* in relation to unaffiliated firms.

2. *Extensions of Credit to Issuers of Securities*

Proposals. The Senate bill prohibited banks from lending to issuers of securities underwritten by affiliates for the purpose of paying principal, interest or dividends on those securities. The bill also prohibited extensions of credit for the purpose of enhancing the marketability of securities underwritten or distributed by securities affiliates. (§ 201, proposed BHCA §§ 4(c)(15)(F)(iii) and (v))

The House Banking Committee and the House Energy and Commerce Committee bills contained provisions similar to those in the Senate bill. (§ 201, proposed BHCA § 9(b); § 201, proposed BHCA § 9(a)(9), (10))

The Federal Reserve Board's Section 20 Orders contain provisions similar to those in the legislative proposals. 1989 Order, Condition No. 5, 7.

Existing Law. Federal and state banking laws limit the amount of credit that may be extended to one borrower. *See, e.g.*, 12 U.S.C. § 84.

Such laws also prohibit unsound lending practices and subject banks to examination and reporting requirements.

Federal banking and antitrust laws prohibit "tying" arrangements and other anti-competitive practices and impose substantial civil (*i.e.* treble damages) and criminal penalties for violations. 12 U.S.C. §§ 1972, 1975, 1976; 15 U.S.C. §§ 1, 14, 45.

The 1933 Act imposes detailed disclosure requirements in connection with offers and sales of securities, including detailed disclosure regarding the financial condition of the issuer. *See* 15 U.S.C. § 77a *et seq.* These provisions would require disclosure of loans made to an issuer by an affiliate of an underwriter.

Analysis. There has been no evidence of unsound lending practices in connection with any of the various securities activities in which banks and their affiliates engage today. In particular, banks routinely make short-term loans to governmental entities that issue securities underwritten by the bank. Banks also issue letters of credit to governmental entities in connection with specific securities issues that are underwritten by the bank. These extensions of credit are subject to normal credit review procedures and are made on terms similar to those included in extensions of credit to comparable customers for whom banks do not perform underwriting services.

The reason that abuses have not arisen in connection with the provision of credit and underwriting services to the same customer is obvious. It would be economically irrational for a bank to risk its assets in an unsound loan simply because an entity has issued securities underwritten and distributed by the bank (or an affiliate). The fees the bank (or an affiliate) might earn in providing underwriting services would pale by comparison to the principal amount of any such loan.

Similarly, the economics of the situation effectively eliminate any possibility that a bank might make an unsound loan to an issuer to make a proposed securities offering more attractive or to "shore up" an issuer for which the bank's affiliate has performed underwriting services. As the Federal Reserve Board has noted in a related context:

> "[B]ecause the potential financial gain to the bank from commercial paper placement activities is so small in relation to the principal amount of loans that would be extended by the bank, the Board does not believe that it is reasonable to assume that the bank would risk its own funds by making loans to issuers to shore up the issuer's financial condition or to make its obligations more acceptable to the market."

Commercial Paper Statement at 40-41.

Moreover, any concern about "tying" arrangements involving banks and affiliated securities firms is squarely addressed by provisions of existing law that make it *per se* illegal for banks to extend credit (or adjust the price of such credit) on the condition or requirement that a customer purchase some other product or service from affiliates, including securities affiliates. 12 U.S.C. § 1972 (Section 106(b) of the Bank Holding Company Act Amendments of 1970).

Finally, a prohibition against lending to issuer-clients puts U.S. banks at a competitive disadvantage in relation to foreign banks that can provide both lending and underwriting services to their customers.

3. *Extensions of Credit to Purchasers of Securities*

Proposals. The Senate bill prohibited banks, bank holding companies and their nonbank subsidiaries (other than securities affiliates) from knowingly extending credit secured by or for the purpose of purchasing any security while, or for 30 days after, that security is the subject of a distribution in which a securities affiliate participates as an underwriter or member of a selling group. (§ 102, proposed BHCA § 4(c)(15)(F)(iv))

The House Banking Committee and House Energy and Commerce Committee bills contained provisions similar to the one in the Senate bill. (§ 201, proposed BHCA § 9(c); § 201, proposed BHCA § 9(b))

The Federal Reserve Board's Section 20 Orders contain a provision similar to the one in the legislative proposals, but also generally bar loans to purchase bank-ineligible securities in which affiliates make markets. 1989 Order, Condition No. 6.

Existing Law. Section 7 of the 1934 Act authorizes the Federal Reserve Board to issue regulations governing loans to finance the purchase of equity securities. 15 U.S.C. § 78g.

The Federal Reserve Board's "margin" regulations apply to lenders that finance the purchase or carrying of margin stock when the lenders are secured directly or indirectly by such stock. 12 C.F.R. Parts 207, 220, 221. The regulations restrict the amount of such loans to the maximum loan value of the collateral, which in the case of margin securities is currently half their market value.

Section 11(d)(1) of the 1934 Act prohibits a securities firm from directly or indirectly arranging for the extension or maintenance of credit to or for a customer on any security which was part of a new issue in which the firm participated as a member of a selling group within 30 days prior to the extension of credit. 15 U.S.C. § 78k(d)(1).

Federal and state banking laws prohibit banks from engaging in unsound practices and subject banks to examination and regulatory oversight.

Analysis. There has been no evidence that banks have engaged in unsound lending practices in connection with the securities activities in which they, and their affiliates, currently engage. Moreover, any concern in this regard is based on the illogical and highly questionable assumption that banks would jeopardize their own assets so that their affiliates could earn a small fraction of the amount of those assets on the sale of securities.

Moreover, it is well-recognized that few investors (other than broker-dealers) borrow to buy corporate bonds and that most loans to purchase equity securities (excluding loans to finance major corporate acquisitions) are smaller loans to individuals rather than larger loans to institutional investors. In addition, loans to purchase equity securities, as noted above, are subject to the provisions of the 1934 Act and the Board's "margin" regulations.

In light of these practical realities and the provisions of current law, there is no need to add a specific restriction on banks' ability to extend credit to potential investors in securities underwritten or dealt in by their affiliates.

C. Bank Transaction Firewalls

1. *Purchases of Securities Underwritten by Securities Affiliates*

Proposals. The Senate bill extended the prohibition in Section 23B (see below) by 30 days. Pursuant to this provision, a bank would be prohibited from knowingly purchasing securities for which its affiliate is a principal underwriter during, and for 30 days after, the underwriting period. (§ 106)

The House Banking Committee bill imposed a prohibition similar to the one in the Senate bill, except that it would have extended for 90 days following the underwriting period. This prohibition would have applied to all securities for which a securities affiliate is an underwriter or member of a selling group (whether or not the affiliate is a "principal underwriter" under Section 23B. (§ 201, proposed BHCA § 9(a)(3))

The House Energy and Commerce Committee bill contained a provision essentially identical to the House Banking Committee provision, except that the restriction would have applied for only 30 days following the underwriting period. (§ 201, proposed BHCA § 9(a)(4))

The Federal Reserve Board's Section 20 orders impose a similar prohibition against purchases of bank-ineligible securities underwritten by affiliates. The restriction applies to purchases by all holding company affiliates (not merely banks), extends to 60 days following the underwriting period, and prohibits purchases of any bank-ineligible securities in which an affiliate makes a market. 1989 Order, Condition No. 19. In its order applying the "firewall" provisions to the U.S. securities activities of *foreign* banking organizations, the Federal Reserve Board stated that "in the case of ineligible securities that are being issued in a simultaneous cross-border underwriting in which the [securities affiliate] and a foreign affiliate or affiliates are participating, such securities may be purchased or sold pursuant to an intersyndicate agreement for the period of the underwriting where the purchase or sale results from *bona fide* indications of interest from customers." Foreign Bank Order, Condition No. 19. This "exception" applies to both U.S. and foreign banking organizations. *Id.*

Existing Law. Section 23B of the Federal Reserve Act prohibits any bank from knowingly purchasing, as principal or fiduciary, during the existence of any underwriting or selling syndicate, any security for which an affiliate of the bank is a principal underwriter. A bank may purchase such securities only if the purchase is approved by a majority of the bank's independent directors before the securities are initially offered for sale to the public. 12 U.S.C. §§ 371c-1, 1828(j).

Section 23A of the Federal Reserve Act prohibits a bank from purchasing "low quality assets" from any affiliate. 12 U.S.C. §§ 371c, 1828(j); *see also* Appendix B.

Section 23A imposes aggregate percentage limits on securities purchases, loans and other transactions between banks and affiliates, and Section 23B requires that such transactions be on arm's-length terms.

The National Bank Act and the Federal Reserve Act prohibit national and state member banks from purchasing equity securities and limit the type, and amount, of debt securities they can purchase for their own accounts. 12 U.S.C. §§24 (Seventh), 335. The regulations implementing this limitation require a bank to determine that the issuer of any debt securities the bank proposes to purchase will be able to meet its obligations and that the bank will be able to sell the securities with reasonable promptness at a price which corresponds reasonably to their fair value. 12 C.F.R. Part 1.

Analysis. No additional restrictions on bank purchases of securities from affiliates are necessary. Adequate safeguards are provided by Sections 23A and 23B, oversight by state and federal banking regulators, and other provisions of state and federal banking law which limit the kinds and amounts of securities banks can purchase for their own accounts. Moreover, prevailing market prices and the requirement that securities affiliates mark their assets to market make it easy for regulators to monitor banks' purchases of securities from their affiliates.

In any event, restrictions on purchases of affiliate-underwritten securities should not be extended to bank holding companies and nonbank affiliates (as the Section 20 Orders do). These entities are not FDIC-insured and purchases by them do not in any way affect the safety and soundness of affiliated banks. *See* J.P. Morgan, 76 Fed. Res. Bull. 26, 28 (1990) ("[T]he Board notes that banks that currently [privately] place securities do place them with the parent company or other nonbank affiliates. No particular supervisory problem has to date arisen from such investments.")

2. *Trust Account Purchases from Securities Affiliates*

Proposals. The Senate bill and the House Banking Committee bill did not amend or supplement current law.

The House Energy and Commerce Committee bill imposed an additional restriction that prohibited a bank from purchasing as fiduciary from a securities affiliate (and prohibited a securities affiliate from selling to an affiliated bank acting as fiduciary) any security underwritten by the securities affiliate, during and for 30 days following the underwriting period, except at the customer's express request. (§ 201, proposed BHCA § 9(a)(5); § 211, proposed 1934 Act § 15D(b)(5))

The Federal Reserve Board's Section 20 orders restrict a bank from purchasing as fiduciary any bank-ineligible securities underwritten by its securities affiliate within 60 days following the underwriting period, or from purchasing any ineligible securities in which the affiliate makes a market, unless such purchases are specifically authorized by the governing trust instrument, by court order or by applicable trust law. 1989 Order, Condition No. 18.

Existing Law. Section 23B prohibits a bank from purchasing as fiduciary any securities or other assets from any affiliate unless such a purchase is permitted under the relevant trust instrument, by court order or under applicable fiduciary laws. 12 U.S.C. §§ 371c-1, 1828(j); *see also* 12 C.F.R. § 9.12(a) (Comptroller of the Currency regulations restricting fiduciary investments by national banks).

Section 23B bars a bank from knowingly buying as fiduciary any securities for which its affiliate is a principal underwriter, unless the purchase is approved by a majority of independent directors before the public offering.

State trust laws impose additional restrictions on transactions between fiduciaries and their affiliates. Some states, for example, have codified the common law prohibition against self-dealing by state-chartered bank trustees. This prohibition against self-dealing extends to transactions with affiliates or subsidiaries of the trustee.

Analysis. There has been no evidence of abuse in connection with the securities activities in which banks and their affiliates are currently engaged. As the FDIC has noted: "The most likely scenario would be the bank selling securities to its trust accounts underwritten by it or one of its affiliates. However, it appears that while such abuse is a theoretical possibility, in practice it has been virtually nonexistent." FDIC, *Mandate for Change* at 52 (1987).

The 1988 legislative proposals and the Section 20 orders recognized the breadth of existing regulation and proposed few changes in this area. The House Energy and Commerce Committee proposal that a customer specifically *request* such an investment before a bank may purchase affiliate-underwritten securities for a trust account imposes unnecessary burdens and produces no benefits. Section 23B already requires that such investments be permissible under the relevant trust instrument or applicable fiduciary law. To require that a fiduciary customer request an investment in particular securities is unworkable, given the size, diversity and discretionary nature of most fiduciary accounts. Such a requirement would simply deprive fiduciary customers of the judgment and discretion they sought to obtain when they contracted for a bank's fiduciary services.

3. *Purchases of Financial Assets from Securities Affiliates*

Proposals. The Senate bill prohibited banks from purchasing any "financial assets" from securities affiliates. (§102, proposed BHCA §4(c)(15)(F)(i)(II))

The House Banking Committee bill contained an essentially identical restriction. (§201, proposed BHCA §9(a)(2))

The House Energy and Commerce Committee bill proposed expanding this restriction to prohibit banks from purchasing *any* assets from securities affiliates. (§201, proposed BHCA §9(a)(3))

The Section 20 orders contain a restriction similar to the one proposed in the Senate bill, prohibiting banks from purchasing financial assets from, or selling them to, Section 20 affiliates. The Section 20 order specifically exempts purchases and sales of U.S. Treasury securities (other than in connection with repurchase agreements). 1989 Order, Condition No. 22. In its order applying the firewall provisions to the U.S. securities activities of *foreign* banking organizations, the Federal Reserve Board expanded the "U.S. Treasury security" exemption to include direct obligations of the Canadian federal government. Foreign Bank Order, Condition No. 22. The expanded exemption applies to both U.S. and foreign banking organizations.

Existing Law. Section 23A of the Federal Reserve Act limits a bank's asset purchases and other "covered transactions" with any one affiliate to 10% of the bank's capital and surplus, and with all affiliates in the aggregate to 20% of capital and surplus. 12 U.S.C. §§371c, 1828(j).

Section 23A forbids a bank from purchasing any "low quality asset" from an affiliate and requires all transactions with affiliates to be on terms and conditions consistent with safe and sound banking practices.

Section 23B of the Federal Reserve Act requires that transactions with affiliates, including purchases and sales of assets, be conducted on arm's-length terms. 12 U.S.C. §§371c-1, 1828(j).

Analysis. Banks are protected against any possible harm in transactions with affiliates by Sections 23A and 23B of the Federal Reserve Act. Furthermore, banks are subject to perhaps the most extensive supervision and examination of any U.S. industry. Purchases of assets from affiliates are covered, and strictly limited, by Section 23A and they are required to be on arm's-length terms by Section 23B. Prevailing market prices and the requirement that securities affiliates mark their assets to market makes it easy for regulators to monitor banks' purchases of financial assets from their affiliates.

In any event, purchases of U.S. Treasury and other bank-eligible securities from affiliates should not be restricted. Government securities and other bank-eligible securities are not subject to Glass-Steagall Act restrictions, and transactions in such securities are essential to long-standing government securities operations and to hedge financial risks.

Notwithstanding the proposal by the House Energy and Commerce Committee, bank purchases of nonfinancial assets — such as office equipment, premises and leases — from affiliates also should not be restricted. Prohibiting purchases and sales of such assets between banks and affiliates would interfere with holding company reorganizations and destroy important operating efficiencies.

4. *"Tying"*

Proposals. The Federal Reserve Board's Section 20 orders prohibit a bank or thrift from extending, denying or varying the terms of credit "with the intent of creating a competitive advantage" for a Section 20 securities affiliate. 1987 Order, Condition No. 27.

None of the 1988 legislative proposals suggested any restrictions in this area beyond those imposed by existing law.

Existing Law. Section 106(b) of the Bank Holding Company Act Amendments of 1970 makes tying arrangements[17] *per se* illegal.[18] That statute generally forbids any bank from requiring a customer to purchase any other product or service from the bank or its affiliates, or to refrain from purchasing products or services from a competitor, as a condition of obtaining credit or any other service from the bank. Section 106(b) provides for treble damages and injunctive relief. 12 U.S.C. §§ 1972, 1975, 1976. The Federal Reserve Board has extended this prohibition to bank holding companies and their nonbanking subsidiaries. 12 C.F.R. § 225.4(d).

Tying arrangements can also constitute violations of federal antitrust laws, including Section 3 of the Clayton Act, Section 1 of the Sherman Act and Section 5 of the Federal Trade Commission Act. *See* 15 U.S.C. §§ 14, 1 and 45, respectively. These laws are enforced by private lawsuits, the FTC and the Department of Justice and impose treble damages and other substantial penalties.

Analysis. There is no evidence that "tying" has been, or will be, a problem and there is no reason to believe that the existence of securities affiliates would present any greater risk of tying than the existence of any other bank affiliates. As noted above, existing prohibitions against tying impose severe penalties and are enforced by a variety of regulatory authorities, as well as through private lawsuits encouraged by the availability of treble damages.

The competitive nature of today's credit markets greatly reduces the likelihood of tying in any event. Any institution that attempted to impose uncompetitive terms through tie-ins would quickly lose customers to competing banks and securities firms.

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[17] A "tying arrangement" is any arrangement in which a bank requires a customer that desires one service, such as credit, to purchase other services or products from the bank or its affiliates as a condition of receiving the first service.

[18] Under Section 106(b), a person challenging bank practices need only prove the existence of a tying arrangement. There is no need to demonstrate that the bank has significant market power or that the tying arrangement has in fact impaired competition.

5. *Discrimination Against Unaffiliated Securities Firms*

Proposals. The House Banking Committee bill prohibited any bank from providing products or services to customers of its securities affiliate except on terms substantially the same as, or at least as favorable to the bank as, transactions with third parties that are not customers of the securities affiliate. (§ 201, proposed BHCA § 9(d))

The House Energy and Commerce Committee bill contained the same provision as the House Banking Committee bill. (§ 201, proposed BHCA § 9(c). The House Energy and Commerce Committee bill also would have prohibited a bank from extending, denying or varying the terms of credit if the "effect" of such action would be to discriminate against an unaffiliated securities firm or "with the intent of creating a competitive advantage" for the bank's securities affiliate. (§ 201, proposed BHCA § 9(k))

The Federal Reserve Board's Section 20 orders contain restrictions similar to the ones contained in the House Energy and Commerce Committee bill. 1989 Order, Condition No. 27.

The Senate bill proposed no such restrictions.

Existing Law. Federal banking and antitrust laws prohibit tying arrangements and other anti-competitive practices. 12 U.S.C. §§ 1972, 1975, 1976; 15 U.S.C. §§ 1, 14, 45.

Section 23B of the Federal Reserve Act requires transactions between banks and their affiliates to be on arm's-length terms. 12 U.S.C. §§ 371c-1, 1828(j).

Analysis. Restrictions on the terms of bank transactions with customers and securities firms are unnecessary, burdensome and unfair. The proposed prohibitions against transactions that might have the "effect" of treating securities firms "less favorably," or with an "intent" to create a competitive advantage, are vague and unworkable. These proposals could have the effect of requiring a bank to document and support against potential challenges by competitors virtually every transaction with any securities firm, with any customer of its securities affiliate or, indeed, with anyone having any contact with the bank's securities affiliate. Banks should not be subjected to such anti-competitive prohibitions. Securities firms competing with banks would face no comparable restrictions.

Existing law already prohibits tying arrangements and anti-competitive practices and subjects banks to extensive supervisory oversight. Moreover, banks and their affiliates have long competed vigorously with the securities industry in several areas, including the government securities market and securities markets abroad, and there is no evidence that banks have discriminated against securities firms. In fact, banks have a long history of lending to their competitors. In any event, market pressures make it virtually impossible for any bank to impose uncompetitive market terms on securities firms; there is simply too much competition for any institution to be able to enforce a discriminatory policy.

6. *Underwriting Asset-Backed Securities Issued by Affiliated Banks*

Proposals. The Federal Reserve Board's Section 20 orders prohibit securities affiliates from underwriting or dealing in any bank-ineligible securities issued by affiliates, or backed by obligations originated or sponsored by affiliates, *except* for securities that are (i) rated by a nationally recognized rating organization; (ii) issued or guaranteed by FHLMC, FNMA or GNMA; (iii) backed by FHLMC, FNMA or GNMA obligations; or (iv) issued by grantor trusts or special purpose entities formed for the purpose of issuing securities backed by mortgages originated by non-affiliated lenders. 75 Fed. Res. Bull. 751 (1989).

The Senate bill imposed similar restrictions, but would have restricted only the underwriting of asset-backed securities issued by affiliated banks or thrifts. The bill also would not have restricted a securities affiliate from *dealing* in such securities in the secondary market. (§ 102, proposed BHCA § 4(c)(15)(F)(x))

The House Banking Committee bill contained a similar provision, but would have exempted any securities sold in private placements or exclusively to institutional and sophisticated investors. The House Banking Committee bill also would not have restricted a securities affiliate from dealing in such securities in the secondary market. (§ 201, proposed BHCA § 9(i))

The House Energy and Commerce Committee bill would have permitted a bank securities affiliate to underwrite asset-backed securities issued by affiliates only if (a) the securities were rated investment grade, or the securities were issued, guaranteed or backed by FHLMC, FNMA or GNMA, *and* (b) an independent underwriter was involved in the preparation of offering documents and the pricing of the securities. (§ 201, proposed BHCA § 9(h))

Existing Law. Federal and state laws generally permit securities firms to underwrite securities issued by affiliates, provided appropriate disclosures are made in securities offering documents and National Association of Securities Dealers ("NASD") rules are satisfied. Schedule E to the NASD by-laws imposes numerous safeguards on the sale and underwriting of securities by broker-dealers for affiliates. These include disclosure requirements, a suitability rule regarding customer investments in such securities, prohibitions on sales of such securities to broker-dealer discretionary accounts, and a requirement that an independent underwriter participate in pricing such securities unless they are rated Baa or better or are equity securities having a well-established independent market. Securities firms not affiliated with bank holding companies routinely underwrite securities issued by affiliates.

Federal law, state securities registration, blue sky and antifraud laws require extensive disclosures of all material facts in the offering and sale of securities, including asset-backed securities. These requirements are enforced by the SEC and state regulatory authorities and through private lawsuits. *See, e.g.*, 15 U.S.C. §§ 77a *et seq.* and 78a *et seq.*

Analysis. In *SIA* v. *Clarke*, 885 F.2d 1034 (1989), the U.S. Court of Appeals for the Second Circuit held that the Glass-Steagall Act does *not* prohibit banks from selling interests in pools of their mortgage loans to the public. The court concluded that the issuance and sale of asset-backed securities is part of the business of banking. The Supreme Court denied the SIA's petition for review. 110 S. Ct. 1113 (1990). In light of this decision, the sale of securities backed by obligations originated by an affiliate should be treated as a "bank eligible" activity.

Even assuming that the sale of such securities is not treated as bank eligible, there is no justification for restricting the ability of a securities affiliate to do indirectly what the bank can do directly. Federal and state securities laws, SEC broker-dealer regulation and NASD rules provide sufficient safeguards in any event. Securities firms have long underwritten asset-backed and other securities issued by their affiliates under this regulatory structure. Securities affiliates of banks should not be subjected to restrictions that are patently anti-competitive and unrelated to bank safety and soundness.

The "temptation" to securitize uncreditworthy assets is purely hypothetical. Banking organizations have issued large volumes of asset-backed securities in recent years, often without third-party underwriters, with no evidence of problems or abuse. The nature of the asset-backed securities markets, which are almost exclusively limited to sophisticated and institutional investors, makes it highly unlikely that any issuer could "dump" bad assets through the sale of asset-backed securities.

Finally, issuers are effectively prevented from "hiding" bad assets in securitized pools because of the extensive disclosures required in securities offering documents regarding the assets being sold and the potentially enormous liability associated with any misstatements or omissions.

APPENDIX A

Sections 23A and 23B of the Federal Reserve Act—Text

(12 U.S.C. §§371c, 371c-1)

§ 371c. Banking affiliates

(a) Restrictions on transactions with affiliates

(1) A member bank and its subsidiaries may engage in a covered transaction with an affiliate only if—

(A) in the case of any affiliate, the aggregate amount of covered transactions of the member bank and its subsidiaries will not exceed 10 per centum of the capital stock and surplus of the member bank; and

(B) in the case of all affiliates, the aggregate amount of covered transactions of the member bank and its subsidiaries will not exceed 20 per centum of the capital stock and surplus of the member bank.

(2) For the purpose of this section, any transaction by a member bank with any person shall be deemed to be a transaction with an affiliate to the extent that the proceeds of the transaction are used for the benefit of, or transferred to, that affiliate.

(3) A member bank and its subsidiaries may not purchase a low-quality asset from an affiliate unless the bank or such subsidiary, pursuant to an independent credit evaluation, committed itself to purchase such asset prior to the time such asset was acquired by the affiliate.

(4) Any covered transactions and any transactions exempt under subsection (d) of this section between a member bank and an affiliate shall be on terms and conditions that are consistent with safe and sound banking practices.

(b) Definitions

For the purpose of this section—

(1) the term "affiliate" with respect to a member bank means—

(A) any company that controls the member bank and any other company that is controlled by the company that controls the member bank;

(B) a bank subsidiary of the member bank;

(C) any company—

(i) that is controlled directly or indirectly, by a trust or otherwise, by or for the benefit of shareholders who beneficially or otherwise control, directly or indirectly, by trust or otherwise, the member bank or any company that controls the member bank; or

(ii) in which a majority of its directors or trustees constitute a majority of the persons holding any such office with the member bank or any company that controls the member bank;

(D)(i) any company, including a real estate investment trust, that is sponsored and advised on a contractual basis by the member bank or any subsidiary or affiliate of the member bank; or

(ii) any investment company with respect to which a member bank or any affiliate thereof is an investment advisor as defined in section 80a-2(a)(20) of Title 15; and

(E) any company that the board determines by regulation or order to have a relationship with the member bank or any subsidiary or affiliate of the member bank, such that covered transactions by the member bank or its subsidiary with that company may be affected by the relationship to the detriment of the member bank or its subsidiary; and

(2) the following shall not be considered to be an affiliate:

(A) any company, other than a bank, that is a subsidiary of a member bank, unless a determination is made under paragraph (1)(E) not to exclude such subsidiary company from the definition of affiliate;

(B) any company engaged solely in holding the premises of the member bank;

(C) any company engaged solely in conducting a safe deposit business;

(D) any company engaged solely in holding obligations of the United States or its agencies or obligations fully guaranteed by the United States or its agencies as to principal and interest; and

(E) any company where control results from the exercise of rights arising out of a bona fide debt previously contracted, but only for the period of time specifically authorized under applicable State or Federal law or regulation or, in the absence of such law or regulation, for a period of two years from the date of the exercise of such rights or the effective date of this Act, whichever date is later, subject, upon application, to authorization by the Board for good cause shown of extensions of time for not more than one year at a time, but such extensions in the aggregate shall not exceed three years;

(3)(A) a company or shareholder shall be deemed to have control over another company if—

(i) such company or shareholder, directly or indirectly, or acting through one or more other persons owns, controls, or has power to vote 25 per centum or more of any class of voting securities of the other company;

(ii) such company or shareholder controls in any manner the election of a majority of the directors or trustees of the other company; or

(iii) the Board determines, after notice and opportunity for hearing, that such company or shareholder, directly or indirectly, exercises a controlling influence over the management or policies of the other company; and

(B) notwithstanding any other provision of this section, no company shall be deemed to own or control another company by virtue of its ownership or control of shares in a fiduciary capacity, except as provided in paragraph (1)(C) of this subsection or if the company owning or controlling such shares is a business trust;

(4) the term "subsidiary" with respect to a specified company means a company that is controlled by such specified company;

(5) the term "bank" includes a State bank, national bank, banking association, and trust company;

(6) the term "company" means a corporation, partnership, business trust, association, or similar organization and, unless specifically excluded, the term "company" includes a "member bank" and a "bank";

(7) the term "covered transaction" means with respect to an affiliate of a member bank—

(A) a loan or extension of credit to the affiliate;

(B) a purchase of or an investment in securities issued by the affiliate;

(C) a purchase of assets, including assets subject to an agreement to repurchase, from the affiliate, except such purchase of real and personal property as may be specifically exempted by the Board by order or regulation;

(D) the acceptance of securities issued by the affiliate as collateral security for a loan or extension of credit to any person or company; or

(E) the issuance of a guarantee, acceptance, or letter of credit, including an endorsement or standby letter of credit, on behalf of an affiliate;

(8) the term "aggregate amount of covered transactions" means the amount of the covered transactions about to be engaged in added to the current amount of all outstanding covered transactions;

(9) the term "securities" means stocks, bonds, debentures, notes, or other similar obligations; and

(10) the term "low-quality asset" means an asset that falls in any one or more of the following categories:

(A) an asset classified as "substandard", "doubtful", or "loss" or treated as "other loans especially mentioned" in the most recent report of examination or inspection of an affiliate prepared by either a Federal or State supervisory agency;

(B) an asset in a nonaccrual status;

(C) an asset on which principal or interest payments are more than thirty days past due; or

(D) an asset whose terms have been renegotiated or compromised due to the deteriorating financial condition of the obligor.

(c) Collateral for certain transactions with affiliates

(1) Each loan or extension of credit to, or guarantee, acceptance, or letter of credit issued on behalf of, an affiliate by a member bank or its subsidiary shall be secured at the time of the transaction by collateral having a market value equal to—

(A) 100 per centum of the amount of such loan or extension of credit, guarantee, acceptance, or letter of credit, if the collateral is composed of—

(i) obligations of the United states or its agencies;

(ii) obligations fully guaranteed by the United States or its agencies as to principal and interest;

(iii) notes, drafts, bills of exchange or bankers' acceptances that are eligible for rediscount or purchase by a Federal Reserve Bank; or

(iv) a segregated, earmarked deposit account with the member bank;

(B) 110 per centum of the amount of such loan or extension of credit, guarantee, acceptance, or letter of credit if the collateral is composed of obligations of any State or political subdivision of any State;

(C) 120 per centum of the amount of such loan or extension of credit, guarantee, acceptance, or letter of credit if the collateral is composed of other debt instruments, including receivables; or

(D) 130 per centum of the amount of such loan or extension of credit, guarantee, acceptance, or letter of credit if the collateral is composed of stock, leases, or other real or personal property.

(2) Any such collateral that is subsequently retired or amortized shall be replaced by additional eligible collateral where needed to keep the percentage of the collateral value relative to the amount of the outstanding loan or extension of credit, guarantee, acceptance, or letter of credit equal to the minimum percentage required at the inception of the transaction.

(3) A low-quality asset shall not be acceptable as collateral for a loan or extension of credit to, or guarantee, acceptance, or letter of credit issued on behalf of, an affiliate.

(4) The securities issued by an affiliate of the member bank shall not be acceptable as collateral for a loan or extension of credit to, or guarantee, acceptance, or letter of credit issued on behalf of, that affiliate or any other affiliate of the member bank.

(5) The collateral requirements of this paragraph shall not be applicable to an acceptance that is already fully secured either by attached documents or by other property having an ascertainable market value that is involved in the transaction.

(d) Exemptions

The provisions of this section, except paragraph (a)(4) of this section, shall not be applicable to—

(1) any transaction, subject to the prohibition contained in subsection (a)(3) of this section, with a bank—

(A) which controls 80 per centum or more of the voting shares of the member bank;

(B) in which the member bank controls 80 per centum or more of the voting shares; or

(C) in which 80 per centum or more of the voting shares are controlled by the company that controls 80 per centum or more of the voting shares of the member bank;

(2) making deposits in an affiliated bank or affiliated foreign bank in the ordinary course of correspondent business, subject to any restrictions that the Board may prescribe by regulation or order;

(3) giving immediate credit to an affiliate for uncollected items received in the ordinary course of business;

(4) making a loan or extension of credit to, or issuing a guarantee, acceptance, or letter of credit on behalf of, an affiliate that is fully secured by—

(A) obligations of the United States or its agencies;

(B) obligations fully guaranteed by the United States or its agencies as to principal and interest; or

(C) a segregated, earmarked deposit account with the member bank;

(5) purchasing securities issued by any company of the kinds described in section 1843(c)(1) of this title;

(6) purchasing assets having a readily identifiable and publicly available market quotation and purchased at that market quotation or, subject to the prohibition contained in subsection (a)(3) of this section, purchasing loans on a nonrecourse basis from affiliated banks; and

(7) purchasing from an affiliate a loan or extension of credit that was originated by the member bank and sold to the affiliate subject to a repurchase agreement or with recourse.

(e) Rulemaking and additional exemptions

(1) The Board may issue such further regulations and orders, including definitions consistent with this section, as may be necessary to administer and carry out the purposes of this section and to prevent evasions thereof.

(2) The board may, at its discretion, by regulation or order exempt transactions or relationships from the requirements of this section if it finds such exemptions to be in the public interest and consistent with the purposes of this section.

(Dec. 23, 1913, c. 6, § 23A, as added June 16, 1933, c. 89, § 13, 48 Stat. 183, and amended Aug. 23, 1935, c. 614, § 327, 49 Stat. 717; June 30, 1954, c. 434, § 1, 68 Stat. 358; Sept. 8, 1959, Pub.L. 86–230, § 1(b), 73 Stat. 457; July 1, 1966, Pub.L. 89–485, §§ 12(a), 13(h), 80 Stat. 241, 243; Oct. 15, 1982, Pub.L. 97–320, Title IV, § 410(b), 96 Stat. 1515; Jan. 12, 1983, Pub.L. 97–457, § 22, 96 Stat. 2509.)

§ 371c-1. Restrictions on transactions with affiliates

(a) In general

(1) Terms

A member bank and its subsidiaries may engage in any of the transactions described in paragraph (2) only—

(A) on terms and under circumstances, including credit standards, that are substantially the same, or at least as favorable to such bank or its subsidiary, as those prevailing at the time for comparable transactions with or involving other nonaffiliated companies, or

(B) in the absence of comparable transactions, on terms and under circumstances, including credit standards, that in good faith would be offered to, or would apply to, nonaffiliated companies.

(2) Transactions covered

Paragraph (1) applies to the following:

(A) Any covered transaction with an affiliate.

(B) The sale of securities or other assets to an affiliate, including assets subject to an agreement to repurchase.

(C) The payment of money or the furnishing of services to an affiliate under contract, lease, or otherwise.

(D) Any transaction in which an affiliate acts as an agent or broker or receives a fee for its services to the bank or to any other person.

(E) Any transaction or series of transactions with a third party—

(i) if an affiliate has a financial interest in the third party, or

(ii) if an affiliate is a participant in such transaction or series of transactions.

(3) Transactions that benefit an affiliate

For the purpose of this subsection, any transaction by a member bank or its subsidiary with any person shall be deemed to be a transaction with an affiliate of such bank if any of the proceeds of the transaction are used for the benefit of, or transferred to, such affiliate.

(b) Prohibited transactions

(1) In general

A member bank or its subsidiary—

(A) shall not purchase as fiduciary any securities or other assets from any affiliate unless such purchase is permitted—

(i) under the instrument creating the fiduciary relationship,

(ii) by court order, or

(iii) by law of the jurisdiction governing the fiduciary relationship; and

(B) whether acting as principal or fiduciary, shall not knowingly purchase or otherwise acquire, during the existence of any underwriting or selling syndicate, any security if a principal underwriter of that security is an affiliate of such bank.

(2) Exception

Subparagraph (B) of paragraph (1) shall not apply if the purchase or acquisition of such securities has been approved, before such securities are initially offered for sale to the public, by a majority of the directors of the bank who are not officers or employees of the bank or any affiliate thereof.

(3) Definitions

For the purpose of this subsection—

(A) the term "security" has the meaning given to such term in section 78c(a)(10) of Title 15; and

(B) the term "principal underwriter" means any underwriter who, in connection with a primary distribution of securities—

(i) is in privity of contract with the issuer or an affiliated person of the issuer;

(ii) acting alone or in concert with one or more other persons, initiates or directs the formation of an underwriting syndicate; or

(iii) is allowed a rate of gross commission, spread, or other profit greater than the rate allowed another underwriter participating in the distribution.

(c) Advertising restriction

A member bank or any subsidiary or affiliate of a member bank shall not publish any advertisement or enter into any agreement stating or suggesting that the bank shall in any way be responsible for the obligations of its affiliates.

(d) Definitions

For the purpose of this section—

(1) the term "affiliate" has the meaning given to such term in section 371c of this title (but does not include any company described in section[1] (b)(2) of such section or any bank);

(2) the terms "bank", "subsidiary", "person", and "security" (other than security as used in subsection (b) of this section) have the meanings given to such terms in section 371c of this title; and

(3) the term "covered transaction" has the meaning given to such term in section 371c of this title (but does not include any transaction which is exempt from such definition under subsection (d) of such section).

(e) Regulations

The Board may prescribe regulations to administer and carry out the purposes of this section, including—

(1) regulations to further define terms used in this section; and

(2) regulations to—

(A) exempt transactions or relationships from the requirements of this section; and

(B) exclude any subsidiary of a bank holding company from the definition of affiliate for purposes of this section,

if the Board finds such exemptions or exclusions are in the public interest and are consistent with the purposes of this section.

(Dec. 23, 1913, c. 6, § 23B, as added Aug. 10, 1987, Pub.L. 100–86, Title I, § 102(a), 101 Stat. 564.)

[1] So in original. Probably should be "subsection".

APPENDIX B

Summary of Practical Impact of Sections 23A and 23B

SUMMARY OF PRACTICAL IMPACT OF SECTIONS 23A AND 23B

Extensions of credit and various other transactions between banks and their affiliates are subject to numerous restrictions, requirements and procedures under Sections 23A and 23B of the Federal Reserve Act and the Federal Reserve Board's Regulation O. Bank transactions with affiliates (a category which is broadly defined) must be on arm's-length terms, must be fully collateralized (and, in most cases, over-collateralized), must be reviewed by management or directors, and are subject to aggregate transaction limits. Approving loans to affiliates—both under Regulation O and internal compliance procedures established by banks—involves not only the banking institution's credit committee and compliance personnel but also review by senior management and, in many cases, by the institution's board of directors.

Section 23A generally requires that all extensions of credit be fully collateralized or over-collateralized. Specifically, Section 23A requires that collateral be maintained in an amount equal to at least 100% of the loan if the collateral consists of cash, government securities or certain money market instruments; 110% of the loan if the collateral consists of state or municipal government securities; 120% if the collateral is other debt instruments or receivables; and 130% if the collateral is stock, leases or other property. Collateral must be valued and required levels maintained on an ongoing basis, with additional collateral set aside as needed. In addition, a bank is flatly prohibited from accepting as collateral for loans to affiliates any securities issued by an affiliate or any low-quality assets (defined to include any assets classified as "substandard", "doubtful", "loss" or "special mention" and assets placed on nonaccrual status, renegotiated or past due). Section 23B requires that all extensions of credit and other covered transactions with affiliates be conducted on arm's-length terms, including credit standards substantially the same or at least as favorable to the bank as those employed in transactions with non-affiliates.

The procedures involved in reviewing and approving bank loans to affiliates are arduous. Requests for credit by an affiliate must satisfy arm's-length credit evaluations as with any other borrower; must meet the stiff collateral requirements of Section 23A; must be reviewed and approved by credit committees, compliance officers, senior management and (often) the board of directors; and are carefully documented at each step. Regulation O, for example, requires board of director approval for loans to affiliates of as little as $25,000 or 5% of a bank's capital and for aggregate loans to any affiliate in excess of $500,000. Compliance and credit procedures developed by individual banks may involve senior management and director review in even smaller transactions. Under Regulation O, lines of credit to affiliates must be reviewed by directors both at the time the facility is established and at least every 14 months thereafter. Regulation O and bank compliance procedures also require detailed record-keeping for such transactions.

In addition to collateral requirements and approval procedures, extensions of credit to affiliates must meet several other rigid tests under Sections 23A and 23B:

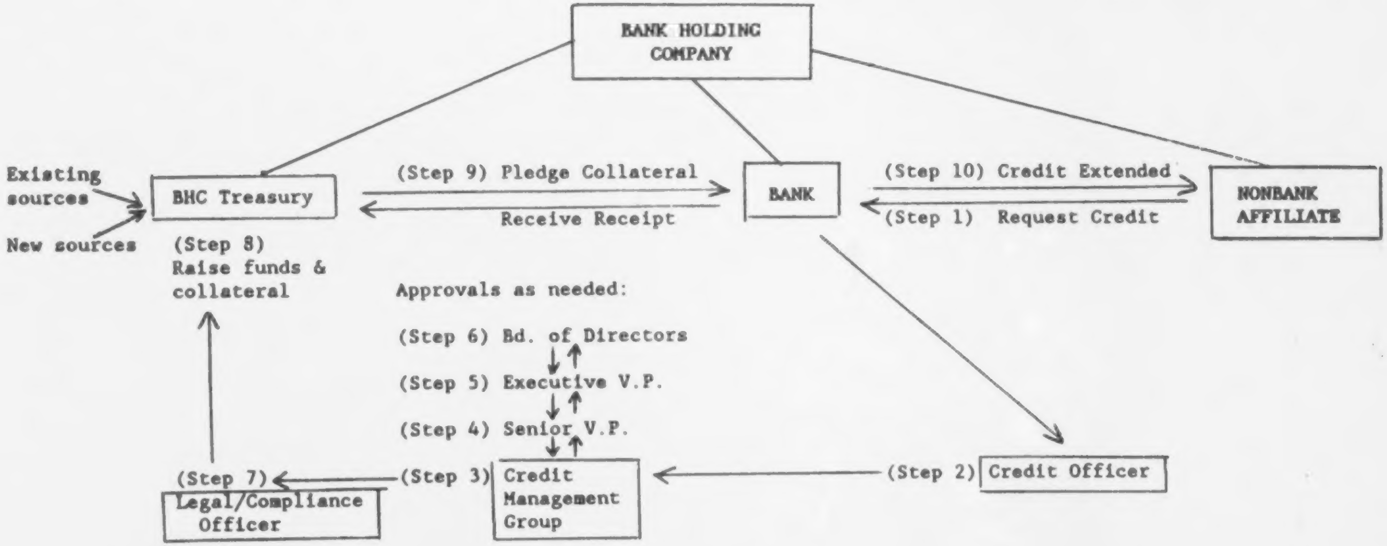
- The amount of loans and other transactions a bank may enter into with affiliates is strictly limited. Extensions of credit and various other "covered transactions" (including, for example, purchases of assets, investments in securities, and guarantees) with any one affiliate in the aggregate may not exceed 10% of a bank's capital and surplus. The aggregate amount of covered transactions with all affiliates is limited to 20% of the bank's capital and surplus.

- Banks are generally forbidden by Section 23A from purchasing low-quality assets from affiliates.
- Banks are prohibited by Section 23B from purchasing as fiduciaries any securities or assets from affiliates, unless such transactions are permitted by the relevant trust instrument, by court order or by applicable law.
- Section 23B bars a bank from purchasing (either as principal or fiduciary) any securities for which an affiliate of the bank is a principal underwriter, unless such purchases are specifically approved by a majority of the bank's independent directors before the securities are initially offered for sale to the public.

These restrictions provide extensive, pervasive and costly safeguards to protect bank assets and insulate banks from the activities of their affiliates. Significant costs and burdens are imposed on banking institutions by the collateral requirements of Section 23A, which can lock up the resources of an institution in assets that are lower-yielding than other banking assets. The level of over-collateralization required by Section 23A is substantial and, for most types of collateral, is far above market standards. Banks and bank holding companies, which are under ratings pressure, may be required to purchase additional assets from other sources to meet these collateral requirements or to satisfy other liquidity and financing needs to which the collateral could otherwise be devoted. The ongoing nature of the collateral maintenance requirements imposes additional burdens. Finally, the time, effort and expense of compliance procedures and personnel—including the involvement of senior management and directors—can be substantial.

The attached chart illustrates one sample compliance procedure that might be followed by a bank in response to a request by a nonbank affiliate for an extension of credit, where the necessary collateral is to be provided by the bank holding company.

SAMPLE PROCEDURE TO COMPLY WITH
SECTIONS 23A AND 23B IN REQUEST FOR
CREDIT BY AFFILIATE WITH COLLATERAL
TO BE PROVIDED BY HOLDING COMPANY


BANK HOLDING COMPANY
Existing sources
New sources
BHC Treasury
(Step 8) Raise funds & collateral
(Step 9) Pledge Collateral
Receive Receipt
BANK
(Step 10) Credit Extended
(Step 1) Request Credit
NONBANK AFFILIATE
Approvals as needed:
(Step 6) Bd. of Directors
(Step 5) Executive V.P.
(Step 4) Senior V.P.
(Step 3) Credit Management Group
(Step 2) Credit Officer
(Step 7) Legal/Compliance Officer

Reviews for Secs. 23A and 23B compliance; determines if collateral required, type and amount; consults with regulatory bodies, as appropriate

Reviews file; evaluates credit; requests approval at appropriate level(s); internal procedures established to comply with FED regulations; approvals required based on amount, type of credit, nature of borrower and compliance officer review; maintains records for examiners on ongoing basis

Reviews request as for any other borrower; checks existing credit file or creates a new commercial credit file; maintains records for examiners on ongoing basis

(Concurrent with Step 7)

APPENDIX C

Firewall Provisions in Section 20 Orders of the Federal Reserve Board

FIREWALL PROVISIONS IN SECTION 20 ORDERS OF THE FEDERAL RESERVE BOARD[1]

A. Capital Adequacy Conditions

1(a). In determining compliance with the Board's Capital Adequacy Guidelines, each Applicant shall deduct from its consolidated primary capital any investment it makes in the underwriting subsidiary that is treated as capital in the underwriting subsidiary. In accordance with the risk-based component of the Board's Capital Guidelines, Applicant shall deduct 50 percent of the amount of any investment in the underwriting subsidiary from Tier 1 capital and 50 percent from Tier 2 capital. In calculating primary capital and risk-based capital ratios, Applicant should also exclude the underwriting subsidiary's assets from the holding company's consolidated assets.

(b). Applicant shall also deduct from its regulatory capital any credit it or a nonbank subsidiary extends directly or indirectly to the underwriting subsidiary unless the extension of credit is fully secured by U.S. Treasury securities, securities that are direct obligations of the Canadian federal government, or other marketable securities and is collateralized in the same manner and to the same extent as would be required under section 23A(c) of the Federal Reserve Act if the extension of credit were made by a member bank.[2] In the case of the risk-based component of the Board's Capital Guidelines, the deductions for unsecured or not fully-secured or inadequately collateralized loans shall be taken 50 percent from Tier 1 and 50 percent from Tier 2 as described above. Notwithstanding these adjustments, Applicant should continue to maintain adequate capital on a fully consolidated basis.[3]

2. No Applicant nor any of its nonbank subsidiaries shall, directly or indirectly, provide any funds to, or for the benefit of, an underwriting subsidiary, whether in the form of capital, secured or unsecured extensions of credit, or transfer of assets, without prior notice to and approval by the Board.

3. Before commencing the new activities, each Applicant must submit to the Board acceptable plans to raise additional capital as required by this Order or demonstrate that it is strongly capitalized and will remain so after making the capital adjustments authorized or required by this Order. An Applicant may not commence the proposed activities until it has received a Board determination that the capital plan satisfies the requirements of this Order and has raised the additional capital required under the plan.

4. The underwriting subsidiary shall maintain at all times capital adequate to support its activity and cover reasonably expected expenses and losses in accordance with industry norms.

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[1] Provisions reprinted from *J.P. Morgan*, 75 Fed. Res. Bull. *192 (1989); as modified by* Order Approving Modifications to Section 20 Orders, 75 Fed. Res. Bull. *751 and order dated Sept. 21, 1989; Bankers Trust New York Corp., 75* Fed. Res. Bull. *829 (1989); J.P. Morgan, 76* Fed. Res. Bull. *26 (1990); and Canadian Imperial Bank of Commerce, 76* Fed. Res. Bull. *158 (1990).*

[2] An extension of credit means any loan, guarantee, or other form of credit exposure, including those described in Condition 5.

[3] [Ed.: The Federal Reserve Board has indicated that it expects to reconsider the capital deduction and prior approval requirements of Condition 1. See 76 Fed. Res. Bull. *at 163, 173, 174.]*

B. Credit Extensions to Customers of the Underwriting Subsidiary[4]

5. No Applicant or subsidiary shall directly or indirectly extend credit, issue or enter into a stand-by letter or credit, asset purchase agreement, indemnity, guarantee, insurance or other facility that might be viewed as enchancing the creditworthiness or marketability of an ineligible securities issue underwritten or distributed by the underwriting subsidiary.

6. No Applicant or subsidiary (other than the underwriting subsidiary) shall knowingly extend credit to a customer directly or indirectly secured by, or for the purpose of purchasing, any ineligible security that an affiliated underwriting subsidiary underwrites during the period of the underwriting or for 30 days thereafter, or to purchase from the underwriting subsidiary any ineligible security in which the underwriting subsidiary makes a market. This limitation extends to all customers of Applicant and its subsidiaries, including broker-dealers and unaffiliated banks, but does not include lending to a broker-dealer for the purchase of securities where an affiliated bank is the clearing bank for such broker-dealer.

7(a). No Applicant or any of its subsidiaries may directly or indirectly, extend credit to issuers of ineligible securities underwritten by an affiliated underwriting subsidiary for the purpose of the payment of principal, interest or dividends on such securities. To assure compliance with the foregoing, any credit lines extended to an issuer by any bank holding company or any subsidiary shall provide for substantially different timing, terms, conditions and maturities from the ineligible securities being underwritten. It would be clear, for example, that a credit has substantially different terms and timing if it is for a documented special purpose (other than the payment of principal, interest or dividends) or there is substantial participation by other lenders.

(b). In the case of securities placed by a securities underwriting subsidiary as agent for an issuer, affiliated banks or other affiliates of the underwriting subsidiary may extend credit to the issuer to repay the principal amount of the securities, provided (i) a period of at least three years has elapsed from the time of placement of the securities, (ii) the extensions of credit meet prudent and objective standards, and (iii) such banks or other affiliates maintain detailed and clearly identified documentation regarding credit, collateral, terms and compliance with section 23B of the Federal Reserve Act.

8. Each Applicant shall adopt appropriate procedures, including maintenance of necessary documentary records, to assure that any extension of credit by it or any of its subsidiaries to issuers of ineligible securities underwritten or dealt in by an underwriting subsidiary are on an arm's-length basis for purposes other than payment of principal, interest, or dividends on the issuer's ineligible securities being underwritten or dealt in by the underwriting subsidiary. An extension of credit is considered to be on an arm's-length basis if the terms and conditions are substantially the same as those prevailing at the time for comparable transactions with issuers whose securities are not underwritten or dealt in by the underwriting subsidiary.

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[4] Unless otherwise stated, these conditions shall apply to a subsidiary of the bank or thrift institution to the same extent as they apply to the bank or thrift institution.

9. In any transaction involving an underwriting subsidiary, Applicants' thrift subsidiaries shall observe the limitations of sections 23A and 23B of the Federal Reserve Act as if the thrifts were banks.

10. The requirements relating to credit extensions to issuers noted in paragraphs 5-9 above shall also apply to extensions of credit to parties that are major users of projects that are financed by industrial revenue bonds.

11. Applicants shall cause their subsidiary banks and thrifts to adopt policies and procedures, including appropriate limits on exposure, to govern their participation in financing transactions underwritten or arranged by an underwriting subsidiary as set forth in this Order. The Reserve Banks shall ensure that these policies and procedures are in place at Applicants' subsidiary banks and thrifts and Applicants shall assure that loan documentation is available for review by Reserve Banks to ensure that an independent and thorough credit evaluation has been undertaken in connection with bank or thrift participation in such financing packages and that such lending complies with the requirements of this Order and section 23B of the Federal Reserve Act.

12. Applicants should also establish appropriate policies, procedures, and limitations regarding exposure of the holding company on a consolidated basis to any single customer whose securities are underwritten or dealt in by the underwriting subsidiary.

C. Limitations to Maintain Separateness of an Underwriting Affiliate's Activity

13. There will be no officer, director, or employee interlocks between an underwriting subsidiary and any of the holding company's bank or thrift subsidiaries.[5] The underwriting subsidiary will have separate offices from any affiliated bank or thrift.[6]

D. Disclosure by the Underwriting Subsidiary

14. An underwriting subsidiary will provide each of its customers with a special disclosure statement describing the difference between the underwriting subsidiary and its bank and thrift affiliates and pointing out that an affiliated bank or thrift could be a lender to an issuer and referring the customer to the disclosure documents for details. In addition, the statement shall state that securities sold, offered, or recommended by the underwriting subsidiary are not deposits, are not insured by the Federal Deposit Insurance Corporation or the Federal Savings and Loan Insurance Corporation, are not guaranteed by an affiliated bank or thrift, and are not otherwise an obligation or responsibility of such a bank or thrift (unless such is the case). The underwriting subsidiary should also disclose any material lending relationship between the issuer and a bank or lending affiliate of the underwriting subsidiary as required under the securities laws and in every case whether the proceeds of the issue will be used to repay outstanding indebtedness to affiliates.

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[5] [Ed.: The Federal Reserve Board has indicated that it expects to reconsider the prohibition on such interlocks. 76 Fed. Res. Bull. 158, 166, 173 (1990).]

[6] An underwriting subsidiary may have offices in the same building as a bank or thrift affiliate if the underwriting subsidiary's offices are clearly distinguished from those of the bank or thrift affiliate.

E. Marketing Activities on behalf of an Underwriting Subsidiary

15. No underwriting subsidiary nor any affiliated bank or thrift institution will engage in advertising or enter into an agreement stating or suggesting that an affiliated bank or thrift is responsible in any way for the underwriting subsidiary's obligations as required under section 23B of the Federal Reserve Act.

16. No bank or thrift affiliate of the underwriting subsidiary will act as agent for, or engage in marketing activities on behalf of, the underwriting subsidiary.[7] In this regard, prospectuses and sales literature relating to securities being underwritten or dealt in by an underwriting subsidiary may not be distributed by a bank or thrift affiliate; nor should any such literature be made available to the public at any offices of any such affiliate, unless specifically requested by a customer.[8]

F. Investment Advice by Bank/Thrift Affiliates

17. An affiliated bank or thrift institution may not express an opinion on the value or the advisability of the purchase or the sale of ineligible securities underwritten or dealt in by an affiliated underwriting subsidiary unless the bank or thrift notifies the customer that the underwriting subsidiary is underwriting, making a market, distributing or dealing in the security.

18. No Applicant nor any of its bank, thrift, or trust or investment advisory subsidiaries shall purchase, as a trustee or in any other fiduciary capacity, for accounts over which they have investment discretion ineligible securities (a) underwritten by the underwriting subsidiary as lead underwriter or syndicate member during the period of any underwriting or selling syndicate and for a period of 60 days after the termination thereof, and (b) from the underwriting subsidiary if it makes a market in that security, unless, in either case, such purchase is specifically authorized under the instrument creating the fiduciary relationship, by court order, or by the law of the jurisdiction under which the trust is administered.

G. Extensions of Credit and Purchases and Sales of Assets

19(a). An underwriting subsidiary may not sell to any affiliate that is acting as principal in the transaction, ineligible securities that are underwritten by the underwriting subsidiary during the period of the underwriting and for 60 days after the close of the underwriting period, or any ineligible security in which the underwriting subsidiary makes a market, except that, in the case of ineligible securities that are being issued in a simultaneous cross-border underwriting in which the underwriting subsidiary and a foreign affiliate or affiliates are participating, such securities may be purchased or sold pursuant to an intersyndicate agreement for the period of the underwriting where the purchase or sale results from *bona fide* indications of interest from customers. Such purchases or sales shall not be made for purposes of providing liquidity or capital support to the underwriting subsidiary or otherwise to evade the requirements of this Order. An underwriting subsidiary shall maintain documentation on such transactions.

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[7] This condition does not prevent a bank or thrift from informing its customers of the available services of the underwriting subsidiary.

[8] [Ed.: The Federal Reserve Board has indicated that it expects to reconsider generally the restrictions on marketing activities of affiliated banks and thrifts. 76 Fed. Res. Bull. 158, 166 (1990).]

(b). A bank holding company and its nonbank affiliates may purchase securities placed by its securities underwriting subsidiary as agent for an issuer, provided that purchases by such affiliates in the aggregate amount to less than 50 percent of the issue of securities being placed. Such purchases of placed securities should be incorporated into the policies, procedures and limitations established under Condition 12 above regarding aggregate holding company consolidated exposure to any single customer.

20. An underwriting subsidiary may not underwrite or deal in any ineligible securities issued by its affiliates or representing interests in, or secured by, obligations originated or sponsored by its affiliates (except for grantor trusts or special purpose corporations created to facilitate underwriting of securities backed by assets originated by a non-affiliated lender) unless such securities are rated by a non-affiliated, nationally recognized rating organization or are issued or guaranteed by the Federal National Mortgage Association, the Federal Home Loan Mortgage Corporation, or the Government National Mortgage Association or represent interests in securities issued or guaranteed by such agencies.

21(a). Applicants shall assure that no bank or thrift subsidiary shall, directly or indirectly, extend credit in any manner to an affiliated underwriting subsidiary or a subsidiary thereof; or issue a guarantee, acceptance, or letter of credit, including an endorsement or standby letter of credit, for the benefit of the underwriting subsidiary or a subsidiary thereof.

(b). This prohibition shall not apply to an extension of credit by a bank or thrift to an underwriting subsidiary that is incidental to the provision of clearing services by the bank or thrift to the underwriting subsidiary with respect to securities of the United States or Canada or their agencies, or securities on which the principal and interest are fully guaranteed by the United States or Canada or their agencies, if the extension of credit is fully secured by such securities, is on market terms, and is repaid on the same calendar day. If the intra-day clearing of such securities cannot be completed because of a bona fide fail or operational problem incidental to the clearing process that is beyond the control of the bank or thrift and the underwriting subsidiary, the bank or thrift may continue the intra-day extension of credit overnight provided the extension of credit is fully secured as to principal and interest as described above, is on market terms, and is repaid as early as possible on the next business day.

22. No bank or thrift shall, directly or indirectly, for its own account, purchase financial assets of an affiliated underwriting subsidiary or a subsidiary thereof or sell such assets to the underwriting subsidiary or subsidiary thereof. This limitation shall not apply to the purchase and sale of U.S. Treasury securities or direct obligations of the Canadian federal government that are not subject to repurchase of reverse repurchase agreements between the underwriting subsidiary and its bank or thrift affiliates.

H. Limitations on Transfers of Information

23. No bank or thrift shall disclose to an affiliated underwriting subsidiary, nor shall an underwriting subsidiary disclose to an affiliated bank or thrift, any nonpublic customer information (including an evaluation of the creditworthiness of an issuer or other customer of that bank or thrift, or underwriting subsidiary) without the consent of that customer.

I. Reports

24. Applicants shall submit quarterly to the appropriate Federal Reserve Bank FOCUS reports filed with the NASD or other self-regulatory organizations, and detailed information breaking down the underwriting subsidiaries' business with respect to eligible and ineligible

securities, in order to permit monitoring of the underwriting subsidiaries' compliance with the provisions of this Order.

J. Transfer of Activities and Formation of Subsidiaries of an Underwriting Subsidiary to Engage in Underwriting and Dealing

25. The Board's approval of the proposed underwriting and dealing activities extends only to the subsidiaries described above for which approval has been sought in the instant applications. The activities in the United States may not be conducted by Applicants in any other subsidiary without prior Board review. Pursuant to Regulation Y, no corporate reorganization of an underwriting subsidiary, such as the establishment of subsidiaries of the underwriting subsidiary to conduct the activities, may be consummated without prior Board approval.

K. Limitations on Reciprocal Arrangements and Discriminatory Treatment

26. No applicant nor any of its subsidiaries may, directly or indirectly enter into any reciprocal arrangement. A reciprocal arrangement means any agreement, understanding, or other arrangement under which one bank holding company (or subsidiary thereof) agrees to engage in a transaction with, or on behalf of, another bank holding company (or subsidiary thereof), in exchange for the agreement of the second bank holding company (or any subsidiary thereof) to engage in a transaction with, or on behalf of, the first bank holding company (or any subsidiary thereof) for the purpose of evading any requirement of this Order or any prohibition on transactions between, or for the benefit of, affiliates of banks established pursuant to federal banking law or regulation.

27. No bank or thrift affiliate of an underwriting subsidiary shall, directly or indirectly:

(a) acting alone or with others, extend or deny credit or services (including clearing services), or vary the terms or conditions thereof, if the effect of such action would be to treat an unaffiliated securities firm less favorably than its affiliated underwriting subsidiary, unless the bank or thrift demonstrates that the extension or denial is based on objective criteria and is consistent with sound business practices; or

(b) extend or deny credit or services or vary the terms or conditions thereof with the intent of creating a competitive advantage for an underwriting subsidiary of an affiliated bank holding company.

L. Requirement for Supervisory Review before Commencement of Activities

28. An applicant may not commence the proposed debt and equity securities underwriting and dealing activities until the Board has determined that the Applicant has established policies and procedures to ensure compliance with the requirements of this Order, including computer, audit and accounting systems, internal risk management controls and the necessary operational and managerial infrastructure. In this regard, the Board will review whether Applicants may commence underwriting and dealing in equity securities based on a determination by the Board that they have established the managerial and operational infrastructure and other policies and procedures necessary to comply with the requirements of this Order.

APPENDIX D

"Existing Safeguards for Regulating Transactions Between Banks and Their Affiliates"

(Appendix to the Comptroller of the Currency's
Response to Inquiry by Subcommittee on
Telecommunications and Finance of the
House Energy and Commerce Committee,
Dec. 4, 1987)

APPENDIX

EXISTING SAFEGUARDS FOR REGULATING TRANSACTIONS BETWEEN BANKS AND THEIR AFFILIATES

The existing statutory framework provides numerous safeguards which apply to transactions between a bank and its affiliates. These safeguards protect against preferential lending, tie-in requirements, conflicts of interest, unfair trade practices, and fraudulent or unsafe and unsound practices.

I. Bank Transactions with Affiliates

A. Section 23A

Section 23A of the Federal Reserve Act (12 U.S.C. § 371c) restricts transactions between member banks and their affiliates. Section 18(j) of the Federal Deposit Insurance Act (12 U.S.C. § 1828(j)) extends the coverage of Section 23A to nonmember insured banks. The objective of Section 23A is to prevent the misuse of a bank's resources that might result from the bank's financial transactions with its affiliates. This objective essentially is achieved by:

- placing quantitative limitations on "covered transactions" between a bank and its affiliate;
- establishing collateral requirements (from 100 to 130 percent) for certain transactions;
- requiring that all transactions be on terms and conditions that are consistent with safe and sound banking practices; and
- prohibiting the bank's purchase of low-quality assets from an affiliate.

Section 23A applies to various "covered transactions" between a bank and its affiliates, including --

- loans or extensions of credit to an affiliate;
- the purchase of, or investment in, securities issued by an affiliate;
- the purchase of assets (including assets subject to repurchase) from an affiliate, except for real or personal property specifically exempted by the FRB;
- the acceptance of securities issued by an affiliate as collateral security; and

- the issuance of a guarantee, acceptance or letter of credit (including an endorsement or standby letter of credit) on behalf of an affiliate.

A bank's covered transactions with any single affiliate may not exceed 10 percent of the bank's capital and surplus. Furthermore, the total amount of a bank's transactions with all of its affiliates is limited to 20 percent of the bank's capital and surplus.

B. Section 23B

Section 23B of the Federal Reserve Act (enacted as Section 102(a) of the Competitive Equality Banking Act, (Pub. L. No. 100-86)) places additional limitations on transactions between federally insured banks and their affiliates. The objective of Section 23B is to ensure "arm's length" transactions between a bank and its nonbank affiliates. Section 23B provides that a bank may engage in certain transactions with its affiliate only:

- on terms and under circumstances (including credit standards) that are substantially the same or at least as favorable to the bank and its subsidiary as those prevailing for comparable transactions with nonaffiliated companies, or

- in the absence of comparable transactions, on terms and under circumstances that in good faith would be offered to or would apply to nonaffiliated companies.

In addition to the "covered transactions" of Section 23A, Section 23B applies to the following transactions:

- the sale of securities or other assets to an affiliate including assets subject to a repurchase agreement;

- the payment of money or the furnishing of services to an affiliate under contract, lease or otherwise;

- any transaction in which an affiliate acts as an agent or broker or receives a fee for its services to the bank or to any other person; and

- any transaction or series of transactions with a third party if an affiliate has a financial interest in the third party or an affiliate is a participant in the transactions.

As additional protection, Section 23B prohibits the following:

- A bank's purchase as fiduciary of any securities or other assets from an affiliate unless the purchase is permitted under the instrument creating the fiduciary relationship, by court order or appropriate law.

- A bank's purchase or other acquisition, as principal or fiduciary, during the underwriting period of any security if an affiliate is a principal underwriter (unless the purchase or acquisition is approved by a majority of bank directors who are not officers or employees of the affiliate prior to the offering of the security to the public).

- A bank's advertisement or entering into an agreement stating or suggesting that the bank will be responsible for the obligations of an affiliate.

The definition of "affiliate" under Sections 23A and 23B includes the parent holding company, other nonbank subsidiaries of the parent holding company, or companies that are commonly owned by the bank or parent holding company. A nonbank subsidiary and, for most purposes, a bank subsidiary of a bank or sister bank subsidiaries in a holding company are not covered by the restrictions of Sections 23A and 23B. The Federal Reserve Board may determine on a case-by-case basis that, because of potential detriment to the bank, these subsidiaries should be subject to the coverage of Section 23A.

Under Sections 23A and 23B, any bank transaction with a third person shall be deemed a transaction with an affiliate to the extent that the proceeds of the transaction are used for the benefit of, or transferred to, the affiliate.

II. Lending Limitations: Individual Borrowers

The National Bank Act (12 U.S.C. § 84) limits extensions of credit by a national bank to any single borrower to 15 percent of capital and surplus. Loans secured by readily marketable collateral are permitted up to an additional 10 percent.

II. Lending Limitations: Officers, Directors, and Shareholders

Sections 22(g) and (h) of the Federal Reserve Act (12 U.S.C. §§ 375a and 375b) restrict extensions of credit by a member bank to its executive officers, directors and principal shareholders. These restrictions also apply to officers, directors and principal shareholders of a parent bank holding company, a subsidiary of the holding company, or a company controlled by these persons. The extension of credit must be made on a nonpreferential ("arm's length") basis, and may not involve more than the normal risk of repayment or exceed the individual lending limit of 12 U.S.C. § 84. Loans are allowed only up to a limit prescribed by the regulator with prior approval required for loans of a certain amount (e.g., $25,000 or five percent of the bank's capital or surplus).

Section 106(b) of the Bank Holding Company Amendments Act of 1970 (12 U.S.C. § 1972) establishes similar requirements for extensions of credit made to officers, directors and principal shareholders of correspondent banks.

IV. Purchase of Securities From Directors

Section 22(d) of the Federal Reserve Act (12 U.S.C. § 375) prohibits a member bank from purchasing from any of its directors any securities or other property unless (i) the purchase is made in the regular course of business and on an "arm's length" basis or (ii) the purchase is approved by a majority of the bank's board of directors. Similarly, a member bank may sell securities or other property to a director only if the sale is on an arm's length basis and in the regular course of business.

V. Anti-Tying Restrictions

Section 106 of the Bank Holding Company Amendments Act of 1970 (12 U.S.C. § 1971 et seq.) generally prohibits a federally insured bank from providing services or extending credit on the condition that a customer obtain an additional service of the parent holding company or an affiliate (or refrain from obtaining services of a bank competitor). The Act provides injunctive relief and treble damages as remedies for the injured customer.

VI. Restrictions on Payment of Dividends

Various restrictions apply to the declaration and payment of dividends by a national bank. Dividends may not be paid out of capital (12 U.S.C. § 56). In addition, national banks and state member banks must receive regulatory approval before paying, in any calendar year, dividends exceeding the total of the year's net profits combined with the retained net profits of the preceding two years (less any required transfers to surplus) (12 U.S.C. § 60).

VII. Securities Law Requirements

A. General

The federal securities laws provide a comprehensive framework for the regulation of participants in the securities markets -- such as brokers, dealers, investment companies and investment advisers -- as well as the timely disclosure of relevant information regarding companies whose securities are offered to the public and traded in the nation's securities markets. While banks are exempt from certain of these provisions, bank holding companies and bank subsidiaries and affiliates generally are subject to federal securities law requirements and the safeguards provided by those provisions.

B. Registration and Disclosure Requirements

Section 3(a)(2) of the Securities Act of 1933 (15 U.S.C. § 77c(a)(2)) exempts banks from the registration requirements of that Act with respect to the securities they issue or guarantee. However, bank holding companies and affiliates and subsidiaries of banks are generally not exempt from those registration requirements. Several banking agencies, however, have adopted disclosure regulations governing bank sales of their securities. The Securities Exchange Act of 1934 imposes registration and disclosure requirements on banks with publicly traded securities and permits the federal bank regulatory agencies to promulgate and enforce periodic reporting and proxy regulations which are substantially similar to comparable Securities and Exchange Commission regulations. See 15 U.S.C. § 78l(i).

C. Anti-Fraud Provisions

All banks and their affiliates are subject to the anti-fraud provisions of the federal securities laws in connection with their securities transactions. Under these laws it is unlawful to employ any device, scheme or artifice to defraud or to make any untrue statement of a material fact, or to omit to state a material fact necessary to prevent a statement previously made from being misleading, or to engage in any other act or practice or course of business which would operate as a fraud or deceit on a person in connection with the purchase or sale of any security.

D. Conflicts of Interest Safeguards

Disclosure of material information to investors and shareholders is a basic principle underlying the securities laws. Specific disclosure obligations established under the Securities Act of 1933 and Securities Exchange Act of 1934, as well as the antifraud provisions referred to above, would require the affirmative disclosure of significant conflicts of interest in registration statements, proxy statements, or other documents filed by banks and other companies pursuant to those acts. For example, if a corporation proposed to use the proceeds of a securities offering underwritten by a bank affiliate to repay a loan to the bank, that fact would have to be disclosed in the prospectus.

In addition, numerous other provisions of the federal securities laws impose substantive regulatory requirements on many classes of securities professionals and entities, including brokers, dealers, municipal and government securities dealers, investment advisers and investment companies. Several of these provisions are designed specifically to regulate activities related to conflicts of interest. See, e.g., Section 17 of the Investment Company Act of 1940, 15 U.S.C. 80a-17, governing transactions of investment companies with affiliates; Section 36 of the Investment Company Act of 1940, 15 U.S.C. § 80a-36, governing breaches of fiduciary duties of investment companies and their advisers; Section 206(3) of the Investment Advisers Act of 1940, 15 U.S.C. § 80b-6(3), governing prohibited transactions by investment advisers; and the Trust Indenture Act of 1939, 15 U.S.C. §§ 77aaa et seq., governing generally the distribution of debt obligations pursuant to indenture.

D. Use of Credit in Securities Markets

Investor use of credit in the securities markets is subject to extensive regulatory oversight. Section 7 of the Securities Exchange Act (15 U.S.C. § 78g) authorizes the FRB to promulgate regulations governing the amount of credit which may be used to finance the purchase of any security. The FRB has adopted regulations covering extensions of credit by brokers and dealers (Regulation T) and by banks (Regulation U). It also has regulations covering extensions of credit by persons other than brokers, dealers and banks (Regulation G), the obtaining of credit by persons other than brokers or dealers (Regulation U) and arranging for others to extend credit in the securities markets (Regulations G, T and U). In addition to regulations covering extensions of credit, brokers and dealers are subject to restrictions governing their borrowing activities.

E. Financial Responsibility Provisions

Brokers and dealers are subject to a number of requirements that safeguard the financial condition of the securities firm and protect customers' funds and securities. Brokers and dealers are subject to minimum capital requirements designed to provide operational safeguards against risks associated with the securities business. See Exchange Act Rule 15c3-1, 17 C.F.R. § 240.15c3-1. Customer funds and securities are protected from a number of risks. For example, brokerage firms must have fidelity bonding insurance to protect customers against dishonesty or misfeasance of employees (NASD Rules of Fair Practice, Section 32). In addition, customer funds and securities must be segregated and generally cannot be used by a firm to support its underwriting and dealer operations. See Exchange Act Rule 15c3-3, 17 C.F.R. § 240.15c3-3.

VIII. Federal Bank Regulatory Authority

A. Examination Authority

The National Bank Act authorizes the OCC to examine a national bank and the affairs of its affiliates as may be necessary to disclose fully the relationship between the entities and the effect of this relationship upon the bank (12 U.S.C. § 481). Pursuant to the Bank Holding Company Act, the FRB is authorized to conduct examinations of the holding company and all subsidiaries of a holding company, including the nonbanking subsidiaries (12 U.S.C. § 1844). In addition, under the Federal Reserve Act, the Board may examine all affiliates of a state member bank (12 U.S.C. § 338). Similar authority is granted to the FDIC with respect to affiliates of insured banks (12 U.S.C. § 1820(b)).

B. Enforcement Authority

- Cease and Desist Authority

  The federal bank regulators have cease and desist authority to address violations of law and unsafe and unsound practices, and violations of any law or regulation by banks under their supervision (12 U.S.C. § 1818). This authority allows the regulatory agencies to institute proceedings requiring any bank or bank holding company (or its directors, officers, employees, or agents) to cease and desist from unsafe and unsound practices or violations of law, and to take whatever affirmative action is necessary to correct the conditions resulting from the violations or practices. In addition, the FRB may require the termination of any holding company activity or a holding company's ownership of any nonbanking subsidiary that is judged to threaten the safety, soundness, or stability of the holding company's banks (12 U.S.C. § 1844(e)). The OCC has similar authority to terminate activities of bank operating subsidiaries.

- Civil Money Penalty Authority

  Various federal statutes (12 U.S.C. §§ 93, 504, 1818, 1828, 1972) give the federal bank regulatory agencies authority to assess civil money penalties against any bank, officer, employee or agent responsible for the violation. In addition, the FRB has civil money penalty authority for violations of the Bank Holding Company Act (12 U.S.C. § 1847). Violations of 23A, 23B and other statutes which restrict transactions between a bank and its affiliates are generally punishable by civil money penalties not exceeding $1,000 per day for each day during which the violation continues.

- Removal Authority

  Federal bank regulators also have authority to suspend or remove any director or officer of an insured bank who has engaged in unsafe and unsound banking practices, a breach of fiduciary duty or violations of law which result in loss to the bank, prejudice to depositors' interests or insider gain, and which involve personal dishonesty or a willful disregard for the bank (12 U.S.C. § 1818(e)). As a result of such a removal, the directors and officers also may be prohibited from participating in the affairs of any other insured bank without the approval of the appropriate federal regulator (12 U.S.C. § 1818(j)).

- Securities Enforcement Powers

  The Federal bank regulators may take administrative actions against banks that act as municipal or government securities dealers, transfer agents or clearing agencies (15 U.S.C. §§ 78o-4(c)(5), 78o-5(c)(2), 78q-1(c), (d)).

- Investigatory Powers

  The federal bank regulators have investigatory powers that extend to a bank, officers, directors or employees or agents of the bank, or its affiliates. The regulators may issue a formal order of investigation which extends to entities or persons which are not national banks or employees of national banks.

C. Reporting Requirements

National banks must file with the Office of the Comptroller of the Currency four times a year reports that disclose fully the relations between a bank and its affiliates (12 U.S.C. § 161). These reports must be verified by the oath of each affiliate's president or other designated officer. State member banks must file identical reports with the FRB three times a year (12 U.S.C. § 334). Any national or state member bank that fails to furnish the required reports is subject to a penalty of $100 for each day the violation continues.

E. Capital Adequacy

The International Lending Supervision Act authorizes federal bank regulators to establish the minimum capital required of banking institutions (12 U.S.C. § 3907). Currently, this rate is six percent of assets. Capital requirements can be changed on a case-by-case basis or for an entire class of banks through general regulations. Banking agencies may issue a directive to require a particular institution to establish a plan to increase its capital.

F. General Rulemaking Authority

Federal banking agencies have general rulemaking authority (e.g., 12 U.S.C. § 93a) which may be used to promulgate new regulations or amend existing regulations as needed to provide appropriate safeguards for banks and their customers.

G. Application and Approval Requirements

The Office of the Comptroller of the Currency requires prior notice and opportunity to disapprove activities to be conducted in national bank subsidiaries. Furthermore, the OCC examines the subsidiary and may take enforcement action or order the termination of any activity that endangers the safety and soundness of the bank. The Bank Holding Company Act requires the FRB to review and approve each application to perform a nonbanking activity, other than activities specifically authorized by statute (12 U.S.C. § 1843(c)(8)).

IX. FDIC's Bona Fide Subsidiary Protections

The FDIC has promulgated regulations to govern bank transactions with affiliated securities companies (12 C.F.R. § 337.4). These provisions permit state chartered nonmember banks to engage in a full range of securities activities through a bank "bona fide" subsidiary or affiliate, provided the activities are authorized under state law. The conditions which must be met for the establishment of a "bona fide" subsidiary include:

- adequate capitalization;
- separation of accounting and other corporation records;
- observance of separate formalities such as separate board of directors' meetings;
- maintenance of separate employees who are compensated by the subsidiary;
- having a majority of directors that are neither officers nor directors of the bank; and
- no common officers with the bank;
- physical separation of the operations;*
- separate name and logo;*
- conducting business pursuant to policies and procedures independent from the bank so as to inform customers that the bank and the subsidiary are separate organizations (including clear disclosure that the obligations of the subsidiary are not obligations of the bank) and subsidiary investments are not insured by the FDIC.*

There are no restrictions on the types of securities that can be underwritten by a subsidiary if: (1) the securities business, whether de novo or by acquisition, has been in continuous operation for five years; (2) it is in good standing with the National Association of Securities Dealers (NASD); (3) its insiders have not been subject to injunction or Securities and Exchange Commission order; and (4) each of its supervisors has five years of experience. Otherwise, underwriting is limited to investment quality debt and equity, shares of mutual funds that invest exclusively in investment quality debt and equity, and shares of money market mutual funds.

Other safeguards for the establishment and operation of a bona fide subsidiary include:

- the requirement that the FDIC be given 60 days notice of intent to establish or acquire a securities subsidiary; and

- restrictions on the extension of credit to a securities subsidiary or affiliate (Section 23A) or to companies the securities of which are to be underwritten by the subsidiary.

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* The FDIC is considering a revision of 12 C.F.R. § 337.4 which will (i) delete the separate name and logo requirement, (ii) modify the requirement for physical separation of the bank and affiliate operations, and (iii) require more specific disclosure requirements under certain circumstances. (Note: The FDIC adopted this revision. See 52 Fed. Reg. 47,379 (Dec. 14, 1987), corrected in 53 Fed. Reg. 597 (Jan. 8, 1988)).

APPENDIX E

Enforcement Powers and Penalties in Federal Regulation of Depository Institutions

ENFORCEMENT POWERS AND PENALTIES IN FEDERAL REGULATION OF DEPOSITORY INSTITUTIONS

Depository institutions, their affiliates and their management face potentially enormous penalties for violations of federal law or regulation—penalties generally far more severe than those applicable to other industries. The enforcement powers and penalties available to federal banking regulators were expanded significantly last year under the Financial Institutions Reform, Recovery, and Enforcement Act ("FIRREA").

The following is only a partial list of the array of enforcement tools and penalties available to federal regulators in overseeing banking institutions and their affiliates:

- **Civil money penalties** of up to $1 million **per day** may be imposed by federal banking regulators on depository institutions and their officers, directors, employees and agents for knowing violations of virtually **any** law, regulation, order or regulatory agreement, or for breaches of fiduciary duty or unsafe and unsound practices.

  Penalties of $25,000 **per day** may be assessed for any violation or breach of fiduciary duty deemed likely to cause more than a "minimal" loss to the institution.

  Inadvertent violations, without prior warning by regulators and without causing any financial loss to a bank, may result in civil money penalties of up to $5,000 **per day**. 12 U.S.C. §§93(b), 481, 504, 1467(i), 1786(k), 1818(i), 1828(j).

- **Criminal penalties** are severe under various statutes. Up to 20 years imprisonment and $1 million fines may be imposed on depository institutions or their officers, directors, employees or agents for certain financial institution related offenses. 18 U.S.C. §§215(a), 656, 657, 1005, 1006, 1007, 1344.

- **Penalties imposed by the Attorney General** may amount to $1 million **per day** or $5 million for financial institution related offenses. These are **in addition** to any civil money penalties assessed by banking regulators for the same offense. FIRREA §951.

- **Civil and criminal forfeiture** of proceeds is required or authorized for certain banking related offenses. 18 U.S.C. §§981, 982. Federal banking regulators also may require restitution through cease and desist orders.

- **Cease and desist orders** issued by banking regulators may require banks and their management, affiliates and agents to take affirmative action to prevent or correct violations or unsafe and unsound practices. This authority has been greatly expanded by changes in law and has been used with increasing frequency in recent years. 12 U.S.C. §1818(b).

- **Removal orders** issued by banking regulators to any person with respect to one institution automatically bar that person from serving as an officer, director or employee of any other insured depository institution in the United States. 12 U.S.C. § 1818(e).

- **Conservators** may be appointed for national banks that are operating in an unsafe and unsound condition, even if they have not yet been determined to be insolvent.

- **Termination of deposit insurance** may be ordered if an institution violates any law, regulation, order or agreement or has engaged in unsafe and unsound practices. 12 U.S.C. §§ 93(a), 501a.

- **Directors and officers liability and penalties** are substantial. A bank's officers, directors, employees and agents may face penalties, regulatory action and liability as "institution affiliated parties." FIRREA § 901. Management also may be held personally liable for breaches of fiduciary duties. Moreover, applicable law and regulatory policy may limit the ability of an institution to indemnify or insure management against such liabilities or penalties.

- **Securities regulation** applies to bank securities affiliates, as it does to all securities firms. Bank securities affiliates would be registered as broker-dealers with, and subject to oversight and enforcement by, the SEC, NASD, state regulators and other regulatory bodies.

- **Nondisclosures under securities laws** create enormous civil liability and penalties, through private lawsuits as well as through regulatory action.

- **Antitrust and anti-tying penalties** are severe, including injunctions, civil money penalties, disgorgement of profits and treble damages. 12 U.S.C. §§ 1972, 1975, 1976; 15 U.S.C. §§ 1, 14, 45.

Questions for Philip Vallandingham (IBAA)
From Senator Nancy Kassebaum
Hearings on Financial Modernization
April 24, 1990

Q.1. I have noted that the IBAA strongly supports the bailout bill's provision restricting brokered deposits. Do you feel that the FDIC is effectively implementing the brokered deposit restrictions? Should we revisit this issue to tighten the restrictions on brokered deposits?

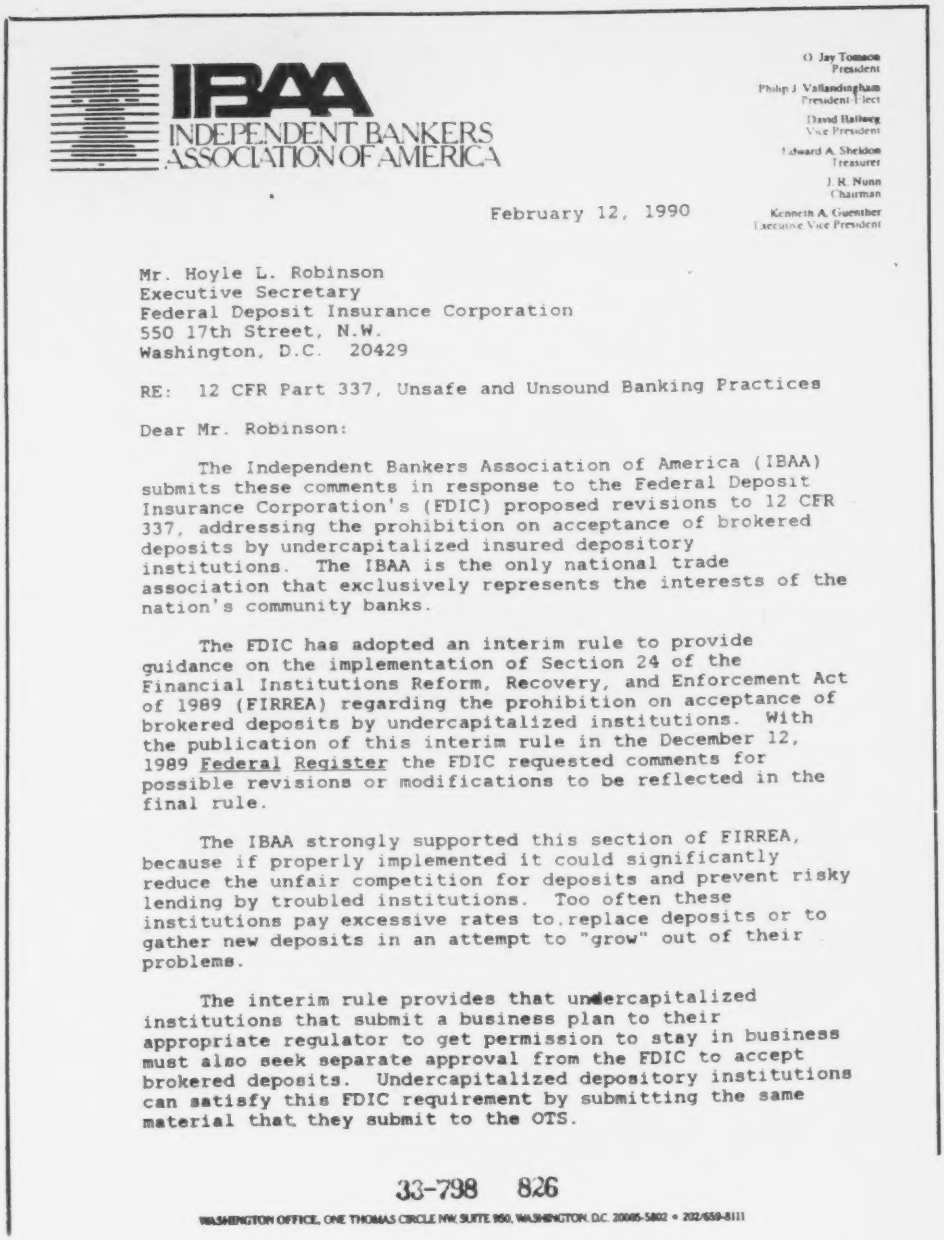
A.1. As stated on page 11 of our testimony, IBAA believes that the provision of FIRREA that prevents undercapitalized institutions from using brokered deposits has significantly contributed to correcting the abuses of brokered deposits by institutions that paid above-market rates and used "hot money" to fund risky activities.

Given the relatively short period of time since the passage of FIRREA, we believe that the FDIC is taking timely action on the brokered deposits restrictions. Although it is too soon to determine how effectively these actions are being implemented, we do not believe that Congress should revisit this issue.

In addition to its post-FIRREA actions, the FDIC is implementing previous plans on controlling the use of brokered deposits. A good example of this is the final ruling it adopted on April 3. This "rapid growth" rule will require insured banks planning to hike their asset base by soliciting, among other things, brokered deposits, to give written explanation of how these funds were obtained to fuel their growth; the rates being paid on these funds; and whether any insider transactions were involved.

In our recent comment letter on the FDIC's proposed revisions to 12 CFR 337, however, we expressed reservations regarding its determination that undercapitalized depository institutions for which the FDIC or the RTC has been appointed conservator or receiver be exempted from the brokered deposits prohibition. We disagree with this exemption because it places healthy depository institutions at an unfair competitive disadvantage with institutions that can offer significantly higher rates, thus increasing for the healthy institutions the cost of funds, increasing the premium, and ultimately, increasing the cost of disposing of undercapitalized institutions.

A copy of our comments on this proposed rule is attached for your review.



IBAA
INDEPENDENT BANKERS
ASSOCIATION OF AMERICA

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Executive Vice President

February 12, 1990

Mr. Hoyle L. Robinson
Executive Secretary
Federal Deposit Insurance Corporation
550 17th Street, N.W.
Washington, D.C. 20429

RE: 12 CFR Part 337, Unsafe and Unsound Banking Practices

Dear Mr. Robinson:

The Independent Bankers Association of America (IBAA) submits these comments in response to the Federal Deposit Insurance Corporation's (FDIC) proposed revisions to 12 CFR 337, addressing the prohibition on acceptance of brokered deposits by undercapitalized insured depository institutions. The IBAA is the only national trade association that exclusively represents the interests of the nation's community banks.

The FDIC has adopted an interim rule to provide guidance on the implementation of Section 24 of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) regarding the prohibition on acceptance of brokered deposits by undercapitalized institutions. With the publication of this interim rule in the December 12, 1989 Federal Register the FDIC requested comments for possible revisions or modifications to be reflected in the final rule.

The IBAA strongly supported this section of FIRREA, because if properly implemented it could significantly reduce the unfair competition for deposits and prevent risky lending by troubled institutions. Too often these institutions pay excessive rates to replace deposits or to gather new deposits in an attempt to "grow" out of their problems.

The interim rule provides that undercapitalized institutions that submit a business plan to their appropriate regulator to get permission to stay in business must also seek separate approval from the FDIC to accept brokered deposits. Undercapitalized depository institutions can satisfy this FDIC requirement by submitting the same material that they submit to the OTS.

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The IBAA supports the separate approval requirement because a business plan that may be adequate to permit an institution to stay in business may not fulfill the requirements to accept brokered deposits. We believe that the FDIC should determine standards that directly affect the deposit insurance fund. This should not impose an unreasonable paperwork burden on troubled institutions since it does not create any new compliance burden.

The interim rule suggests a 50-basis point standard as "significant." This defines brokered deposits as deposits that are obtained from or through the mediation or assistance of a deposit broker, or deposits on which an institution has agreed to pay a rate of interest that is 50 points or greater than the prevailing rates. The IBAA believes this is an appropriate standard, but urges the FDIC to recognize a broader market area than an institutions local area. Community banks often must compete with larger institutions not located in their community for deposits.

Finally, the FDIC has determined that undercapitalized depository institutions for which the FDIC or the Resolution Trust Corporation (RTC) has been appointed conservator or receiver are exempted from the brokered deposits prohibition. The FDIC's reasoning is that these institutions are under FDIC or RTC control and management and therefore pose no risk to the deposit insurance funds, because the FDIC and RTC will "...ensure that such deposits are used only as necessary to meet essential liquidity needs or to minimize losses to the institutions."

The IBAA does not agree with this exemption. The IBAA believes that all undercapitalized insured depository institutions should have to submit an application for exemption. This would achieve the two purposes of limiting brokered deposits: 1) minimizing of losses; and, 2) preventing unfair competition by undercapitalized institutions paying higher rates for deposits. If the FDIC allows undercapitalized depository institutions to accept brokered deposits, healthy depository institutions must compete for deposits against institutions that offer "significantly" higher rates. This can greatly affect an area's cost of funds, increasing the premium and ultimately increasing the cost to the FDIC and the RTC in the disposal of these undercapitalized insured depository institutions.

The IBAA appreciates the opportunity to comment on the FDIC's interim rule. We urge the FDIC to consider our comments when the time comes to write the final rule.

Sincerely,

O. Jay Tomson
President

OJT/jc

American Council of Life Insurance

RESPONSE TO QUESTION FROM
SENATOR RICHARD BRYAN TO
STEPHEN J. FRIEDMAN
HEARINGS ON FINANCIAL MODERNIZATION
April 26, 1990

Q.1 The American Bankers Association has been running a series of ads suggesting that U.S. banks are too small to compete in international markets and that only expanded powers will allow them to achieve adequate size to be competitive. How do insurers respond to that argument?

A.1 As you have indicated, the American Bankers Association placed a number of advertisements suggesting that unless U.S. banks receive additional securities and insurance powers, they are destined for extinction. As proof, the ad includes a listing of the worlds thirty largest banks of which only Citicorp is American. Eighteen of the thirty banks are Japanese. On a relative basis, there is no question that many foreign banks are larger than the largest U.S. banks.

But let us consider how large some of our banking institutions really are, not just compared with Japanese banks, but relative to other types of businesses, many of them considered multinational giants in their own right. Citicorp at $207 billion in assets* is already the largest U.S. corporation by a hefty $30 billion or so over General Motors.

Put in another context, it is larger by itself than the four largest U.S. oil refiners combined (EXXON, Mobil, Texaco and Chevron), larger than the entire U.S. aerospace industry combined (including Boeing, United Technologies, McDonald-Douglas, Rockwell, General Dynamics, Lockheed, Textron, Martin-Marietta and Northrup), larger than the entire U.S. computer industry combined (including IBM, Digital, Hewlett-Packard, Unisys, NCR, Apple, Wang, Pitney Bowes and Cray), larger than the entire U.S. chemical industry combined (including Dupont, Dow, Union Carbide, Monsanto and PPG), and larger than the entire U.S. telecommunications industry combined (including AT&T, United Telecommunications, MCI and EDS).

*SOURCE: Fortune Magazine -- June 1989, April 1990

Of course, none of the other U.S. bank systems are as big as Citicorp, but each of the top 10 have more than $50 billion in assets. Is the suggestion seriously being made that these colossuses cannot compete in world markets?

The Congress should ask itself if the American people really want to concentrate any more economic power in these already giant institutions.

The emphasis on bank size is misplaced for other reasons as well. Japan has most of the world's largest banks, though it is worth noting that they achieved such domination without exercising securities or insurance powers. Their profitability, however, shows no proportional advantage. Quite the contrary. In 1988, the most profitable Japanese bank ranked only fifty-ninth in the world in profitability. The world's largest bank, Japan's Dai Ichi Kangyo, was ranked seventy-fifth in terms of profitability. In contrast, U.S. banks represented twenty-six of the worlds fifty most profitable banks. The U.S. banks that are more profitable than any Japanese bank (and most of the worlds other banks, for that matter) include the following:

Bank	World Profitability Rank
Banc One Corp.	2
J.P. Morgan & Co.	7
Fleet/Norstar Financial	10
Midlantic Corp.	11
Wells Fargo & Co.	12
Manufacturers Hanover Corp.	13
Bankers Trust New York Corp.	14
Chase Manhattan Corp.	15
First Wachovia Corp.	16
PNC Financial Corp.	17
National City Corp.	19
Sovran Financial Corp.	20
Chemical Banking Corp.	21
Suntrust Banks	24
Continental Bank Corp.	25
First Union Corp.	26
Citizens and Southern Corp.	30
Citicorp	31
Bank of New England Corp.	32
NBD Bancorp, Inc.	34
Bank of Boston Corp.	35
Barnett Banks, Inc.	36
Security Pacific Corp.	38
Shawmut National Corp.	43
BankAmerica Corp.	45
NCNB Corp.	46

Source: Real Banking Profitability - December 1989 published by IBCA, Ltd., London (based on net return on assets, adjusted for inflation)

Given a choice, we suspect most bank stockholders would prefer that their bank be profitable rather than merely large.

Significantly, former FDIC Chairman William Isaac recently debunked the size argument noting (5/10/90 American Banker) that American banks had much higher average returns on assets than Japanese banks. He also pointed out that in absolute terms Citicorp earned more profit than any other bank in the world, including all those that are significantly larger. Though only 60% the size of the worlds largest bank, Dai Ichi Kangyo, Citicorp earned 50% more profit. Clearly U.S. institutions can compete quite well against the largest banking institutions.

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